Canada/United States Trade and Investment Issues

Edited by Deborah Fretz,
Robert Stern, and John Whalley

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Contents

FOREWORD ix

INTRODUCTION AND OVERVIEW 3
Deborah Fretz, Robert Stern, and John Whalley

KEYNOTE ADDRESS 21
Jake Warren

CANADA/U.S. TRADE AND INVESTMENT FRICTIONS: THE U.S. VIEW 32
Robert M. Stern

Comments: *Richard G. Harris* 64
Roger Hill 69

CANADA/U.S. ECONOMIC RELATIONS: A CANADIAN VIEW 72
Ronald J. Wonnacott

Comments: *Robert E. Baldwin* 98
William S. Merkin 106

CANADA/U.S. TRADE POLICY ISSUES:
DO WE NEED A NEW INSTITUTION? 113
Rodney de C. Grey

INSTITUTIONAL ARRANGEMENTS FOR MANAGING THE CANADA/U.S. ECONOMIC RELATIONSHIP 126
John M. Curtis

Comments: *William R. Cline* 152
John H. Jackson 158

INVESTMENT FRICTIONS AND OPPORTUNITIES IN BILATERAL CANADA/U.S. TRADE RELATIONS 165
Harvey Bale, Jr.

Comments: *Alan V. Deardorff* 198
Robert G. Logan 207

CANADA/U.S. ENERGY ISSUES: A CANADIAN PERSPECTIVE
David F. Burgess 213

Comments: *John Whalley* 252

ISSUES IN CANADA/U.S. ENERGY TRADE AND INVESTMENT: A U.S. PERSPECTIVE 256
Brendan E. Quirin

CANADA/U.S. AUTOMOTIVE TRADE AND TRADE-POLICY ISSUES 278
Andrew R. Moroz

Comments: *Thomas R. Atkinson* 333
Bernard Ostry 338

CANADA/U.S. TRANSPORTATION ISSUES 341
Kenneth D. Boyer

Comments: *Harold Handerson* 379
Michael Brock 385

CANADA/U.S. TAX RELATIONS: ISSUES AND PERSPECTIVES 391
Richard M. Bird and Donald J.S. Brean

Comments: *Lawrence A. Fox* 426

SUBSIDY PACTS 434
David Conklin

THE BEHAVIOUR OF U.S. SUBSIDIARIES IN CANADA: IMPLICATIONS FOR TRADE AND INVESTMENT 460
Alan M. Rugman

CANADIAN DEFENCE TRADE WITH THE UNITED STATES 474
James C. Bradford

AN ONTARIO PERSPECTIVE ON TRADE ISSUES BETWEEN CANADA AND THE UNITED STATES 478
Roger Hill

POSTSCRIPT 495

Foreword

This workshop on Canada-U.S. Trade and Investment Issues, held at the University of Western Ontario, 18-19 November 1983, was the second in a series of workshops on Canada-U.S. relations organized jointly by the Centre for the Study of International Economic Relations at the University of Western Ontario and the Institute of Public Policy Studies at the University of Michigan-Ann Arbor. The purpose of this workshop series is to bring together members of the academic, policy-making, and business communities to analyse and discuss major issues between Canada and the United States.

The financial assistance of the Ontario Economic Council and the assistance of Council Research Director, David Conklin, and John Curtis of the Institute for Research on Public Policy is gratefully acknowledged. Excellent organizational support for this workshop was provided by Judy Jackson and Helen McCarren at the University of Michigan and by Mary Cassidy and Barb Ross at the University of Western Ontario.

CANADA/UNITED STATES TRADE AND INVESTMENT ISSUES

Introduction and overview

Deborah Fretz
University of Western Ontario
Robert Stern
University of Michigan
John Whalley
University of Western Ontario

This volume contains the papers and discussants' remarks presented at a conference on Canada/United States trade and investment issues sponsored by the Institute of Public Policy Studies of the University of Michigan and the Centre for the Study of International Economic Relations of the University of Western Ontario and held in November 1983. The several papers presented differed substantially in that some were broad, spanning wider aspects of the Canada/U.S. relationship, and others were narrower, looking at sub-areas in more detail.

The organizers of the conference chose session topics and participants so as to explore various dimensions of the Canada/U.S. relationship, particularly as they are likely to emerge in future years. The sharp reaction to the Canadian National Energy Program by the United States and the U.S. reference of Foreign Investment Review Agency (FIRA) content rulings to a GATT panel, reflect the tensions in the relationship which were evident in the early 1980s, and motivated two conference sessions on these topics. Canadian concerns over transportation, tax, auto trade, and other issues, while more muted, were recognized in selecting these as topics for other sessions. In addition, the broader trade issues including the joint participation of both countries in the GATT and possibilities for bilateral trade initiatives (including the recent Canadian proposal for sectoral free trade) were also explored.

The aim of the conference was to lay out the agenda of major trade-related issues of joint concern to the two governments in an interactive business, government, and academic environment. Discussion and debate in the conference itself was simultaneously spirited and constructive, and our hope is that the papers contained in this volume will have a similar catalytic effect on both sides of the border.

SUMMARY OF PAPERS AND COMMENTS

Trade with the United States accounts for a little over 70 per cent of Canadian trade; trade with Canada a little under 30 per cent of U.S. trade. Thus, Canada/U.S. trade is and will continue to be a crucial ingredient of either country's national trade policy. This emerged as a main theme in the papers in the conference, despite nationalistic concerns north of the border, a fair degree of indifference south of the border, and the at times elevated levels of rhetoric along the Ottawa-Washington axis.

Warren on Canada/U.S. frictions

In his keynote address to the conference, Jake Warren discusses the broad nature of Canada/U.S. relations and how political and diplomatic efforts may help to alleviate sources of friction between these two countries. Warren argues that the friction is there because of inherent differences and the high level of interaction between Canada and the United States. However, he adds that the existence of such friction does not imply poor Canada/U.S. relations.

In his discussion of more specific issues, Warren states that he does not feel that a free-trade relationship between Canada and the U.S. is plausible at this time, due principally to Canada's concern that its political autonomy could be undermined by such an association. Warren also feels that the United States and Canada should take the lead in counteracting the current trend toward protectionism in world trade.

Stern on Canada/U.S. trade and investment frictions

In a wide-ranging paper written from a U.S. viewpoint, Robert Stern outlines some of the current points of friction in Canada/U.S. trade and investment. From the U.S. perspective, these include the actions of Canada's Foreign Investment Review Agency (FIRA) and the implementation of the National Energy Program (NEP). The U.S. concern with FIRA is mainly with the discriminatory performance requirements imposed on U.S. affiliates in Canada, requirements that may not only be detrimental to U.S. interests but also constitute a violation of Canada's international obligations. U.S. objections to the

NEP have been focused on the inequity of the 25 per cent Crown share applied retroactively to oil and gas discoveries on federal lands and the system of incentive payments favouring Canadian-owned and Canadian-controlled firms.

Stern suggests that Canada's main concerns are with the U.S. system of contingent protection. This system is seen as a source of uncertainty and harassment that is potentially very damaging to Canadian trade interests. Examples cited in this regard include U.S. actions and investigations affecting Canadian exports of potatoes, softwood lumber, and subway cars. However, while these actions may have been disruptive, Stern notes that each of them was terminated because the allegations of subsidy or material injury were not proven. The U.S. system of contingent protection may therefore function in the end to defuse rather than reinforce protectionism.

Finally, Stern reviews the policy options for responding to Canada/U.S. trade and investment frictions. He favours a combination of inaction, bilateral discussions and negotiations, and multilateral initiatives. A variety of unilateral measures exists, but there is a danger that these measures may become politicized or be transformed along protectionist lines.

In his comments on Stern's paper, Richard Harris notes that the paper does not convey the intensity of feelings in Canada that arise from U.S. dominance and its possibly detrimental impacts on Canadian economic performance and political independence; nor does the paper discuss the importance of federal-provincial relations in the design and conduct of policies. Harris's main concern, however, is that the U.S. system of contingent protection may constitute an important element of uncertainty for Canadian exporters to the U.S. market. This will be especially true if the U.S. market is not 'contestable'. That is, if a substantial and somewhat irreversible capital commitment is required on the part of Canadian exporters to penetrate the U.S. market, the existence of contingent protection may reduce the expected return and increase the risk to Canadian firms. By the same token, he argues that U.S. firms operating in Canada will be less at risk because the Canadian market is smaller and more contestable and thus involves less capital commitment.

Roger Hill's comments focus on the domestic causes and circumstances underlying the various bilateral frictions. These include lobbying pressures on Congress, the clash of political personalities, international spillover effects of U.S. domestic issues, foreign property rights, the effects of recession, the balance of powers between Congress and the President, differences in attitudes about the role of government, and the decline of U.S. hegemony in the world. He recommends more careful consideration by both governments of the foreign impacts of domestic policies.

Wonnacott on Canada/U.S. economic relations

In a paper written from the Canadian perspective, Ronald Wonnacott reiterates the importance to Canada of its trade and investment relations with the U.S., the potential damage that U.S. trade actions could inflict on Canada, and the need for Canada to refrain from actions that may impose significant costs upon itself. He also notes the impacts of the Reagan Administration's macropolicies and the associated high real rates of interest and dollar appreciation that have compounded Canada's domestic problems.

In view of the attention being given to reciprocity as a possible basis for U.S. trade policy, Wonnacott makes a distinction between the different interpretations of the term, which may range from trade liberalization to protectionism. He cites Japan as the potential object of U.S. restrictive actions. If carried out, these actions might benefit Canada if its exports to the U.S. displaced those from Japan. But Canada could just as well be hurt by the eroding of the principle of equal treatment and its own economic and political vulnerability – its own tariffs and other policies could become the object of U.S. reciprocity actions.

Wonnacott has long been a proponent of free trade between Canada and the U.S. on the grounds that it would increase Canada's economic welfare by as much as 5 to 10 per cent of GNP. In reviewing the various arguments, pro and con, from both a Canadian and a U.S. perspective, he notes that both countries would benefit, although it would be important to provide institutional mechanisms to ease the adjustment process in Canada and to guarantee that the policies could not be altered unilaterally by either country. He cites survey evidence that the business community in Canada has become more receptive to a bilateral free-trade initiative. The question then becomes one of policies and timing.

In commenting on Wonnacott's paper, Robert Baldwin notes that in recent years there has been a fundamental change in U.S. trade policy, with a much more aggressive approach now being taken both in response to the policies of other countries and in dealing with conditions domestically. Baldwin attributes this change to the political and economic decline of the U.S. as a world power and the loss of competitiveness in many sectors. Because of the pre-eminence of foreign-policy considerations following World War II, the U.S. was tolerant of extensive free-riding and the lack of full reciprocity by many countries when it came to trade liberalization. With this new element of confrontation and retaliation, the international trading system will likely remain in turmoil until the major powers can act cooperatively and decisively to keep the system together. In these circumstances, Baldwin is skeptical about U.S. acceptance of a bilateral arrangement with Canada that deals only with trade and leaves intact existing Canadian policies involving domestic subsidies, FIRA performance requirements, provincial restrictions, and differences in social welfare and tax policies.

In his comments, William Merkin notes that, while Canada/U.S. relations are now more harmonious, many of the restrictive policies that Canada instituted in 1980/1 are nonetheless still in place. These include the NEP, FIRA, border broadcasting, compulsory licensing of pharmaceutical patents, discriminatory postal rates, and the extension of Canada's customs territory. Merkin suggests that the Canadian government should take a much stronger stand than it has in resisting protectionist pressures. He notes the recent Canadian initiative for sectoral free-trade arrangements, but, like Baldwin, stresses that many related Canadian policies would have to be changed to convince the U.S. that it would benefit from such an arrangement.

Grey and Curtis on institutional arrangements for managing Canada/U.S. economic relations

In his paper on the process through which the bilateral relationship is conducted, Grey questions whether any new institution is likely to make it easier to resolve trade and related policy issues between Canada and the U.S. In his view, there are 'perceived' differences of interest between the two countries, but these differences are not real when one considers the conduct of Canada/U.S. relations as a positive rather than a zero-sum game. This is not, of course, to say that there may well be times when one or the other country will pursue mistaken policies and perceptions. Grey cites the exemption of Canada from the

U.S. interest-equalization tax in the 1960s and the Nixon import surcharges of 1971 as a recognition that it was not in the U.S. interest to harm Canada. In other instances, such as in matters concerning border broadcasting and extraterritoriality, he maintains that the issues have not been thought through clearly in terms of whose interests are being protected or served. On balance, Grey believes that Canada is often affected adversely by ill-conceived U.S. actions aimed at other countries. When disputes arise, they are best addressed, in Grey's view, in the context of the GATT rules by the national representatives. Specialized bilateral institutions and high-level consultative mechanisms have the disadvantage that they cannot deal with issues which become highly politicized. Grey concludes that perception, will, and understanding are what is required, and that the existing institutions suffice.

Curtis in his paper notes the asymmetric relation between the U.S. and Canada, and the fact that most Canadian policies will inevitably bear on U.S. interests, whereas U.S. policies are usually undertaken in a global context and coincidentally have side-effects on Canada. In considering the need for new institutional arrangements, Curtis reviews the historical development of Canada/U.S. agreements, multilateral economic management after World War II in the GATT, OECD, IMF, BIS, and the World Bank, bilateral management at the federal and provincial/state levels, and the extensive private-sector contacts and involvement. He identifies four essential functions to promote more effective bilateral management, including information flows, co-operative research and analysis, continuing consultation at the federal level, and facilities to resolve bilateral disputes.

In his comments, William Cline notes that the institutional arrangements between the U.S. and Canada will depend on the objectives being sought. These can be modest or far-reaching as, for example, if there were a major initiative for a bilateral free-trade arrangement. Cline is concerned about the impact that bilateral arrangements would have on the most-favoured-nation (MFN) traditions of the U.S. and Canada and the possibly detrimental effects on third countries. If bilateral free trade is pursued, he notes that Canada will stand to gain significantly, but not without risk because of the increased competition from U.S. firms and possible restrictions which may be introduced in the U.S. market.

John Jackson takes issue with Grey's emphasis on the importance of perception, will, and understanding. He argues that institutions do indeed matter, and, in view of existing frictions, it may well be that the existing institutions are not functioning well. Jackson reviews the pros and cons of bilateral versus multilateral initiatives from the standpoint of each country, and he suggests that the costs and benefits of the various alternatives be assessed. It is conceivable that the greatest gain might come from a bilateral initiative which then could be made available to other countries on a MFN basis.

Bale on Canada/U.S. investment frictions

In a paper on Canada/U.S. investment issues, Harvey Bale notes the close links between investment policy and trade issues, especially insofar as Canadian investment policy may involve trade-performance requirements. Further, there are differences in policies, with the U.S. citing the benefits of inward investment flows and problems of foreign restrictions and the Canadians being concerned about the degree of foreign ownership and whether Canada derives 'significant benefits' from inward investment.

With respect to FIRA, Bale notes that the low rejection rate for foreign investment applications is misleading since it makes no allowance for applications withdrawn or never submitted. FIRA's actions impose uncertainty and added costs because the screening criteria are not explicit. Data on U.S. direct investment show a sharp decline in the share going to Canada since 1974, and most of the investment that has occurred has been through reinvested earnings by existing foreign affiliates not subject to FIRA review. Bale cites numerous examples of FIRA actions and performance requirements which are detrimental to U.S. trade and investment interests. He notes, however, that the FIRA process has been noticeably liberalized since the end of 1982.

Bale poses the questions of why foreign firms tolerate performance requirements, and suggests that it may be because the host government provides protection and incentives which more than compensate for the requirements. The evidence suggests, however, that performance requirements may have become more stringent, which is bound to reduce profitability, and that safeguards to limit the extension of these policies are currently inoperative.

While the Canadian authorities cite numerous U.S. restrictions on foreign investment, Bale contends that U.S. policies are not discriminatory in the same sense as FIRA and the NEP with regard to national treatment. Moreover, the data suggest a very large inward flow of investment into the U.S., which would belie any serious restrictions.

In his comments, Alan Deardorff considers possible theoretical conditions under which investment performance requirements may be beneficial or harmful to the host and investing countries. For example, a local content requirement might be beneficial on second-best grounds in cases where there is a tariff on imports of final goods and foreign firms enter to get behind the tariff wall. Another example is a labour-content subsidy to offset a subsidy to foreign capital. Deardorff was not able to construct cases in which an export performance requirement would be beneficial since this requirement always ended up adding to rather than lowering costs to firms. If, however, countries face a foreign exchange constraint in their ability to sell exports, an export performance requirement might make some sense.

Robert Logan places great emphasis on the role of foreign capital in Canada's development, especially in industries embodying advanced technology and labour skills. At the same time, foreign affiliates such as IBM Canada find it in their interest to employ primarily Canadians, develop certain product lines for export, source as much as they can logically, conduct R&D, spread the benefits of their technology, maintain regional balance, and participate broadly in Canada's social and cultural life. By the same token, Logan recognizes that federal and provincial investment requirements can be detrimental and will have to be modified if Canada is to prosper in the Information Age which is now unfolding.

Burgess on Canada/U.S. energy issues

David Burgess deals with a number of Canada/U.S. energy issues in the areas of pricing, trade, and foreign ownership. While government intervention in energy markets is an attempt to deal with equity issues both interregionally and interpersonally, Burgess feels that such intervention has created difficulties with respect to the economic efficiency of the energy sector. For example, while the U.S. has decontrolled the domestic price of crude oil, Canada has not, and the lower Canadian price gives consumers false signals as to the true cost of oil. Burgess also thinks that the domestic price of natural gas in

Canada should not be set as currently, at a fixed ratio of the price of oil, because this will result in inappropriate consumer substitution between the two fuels. As well, if export market conditions, rather than political factors determine prices, the Canadian export price of natural gas is probably too high and the export price of electricity too low. Discussing Canada's National Energy Program (NEP), Burgess feels that, contrary to prevailing opinion in the U.S., the program is not a radical departure from previous Canadian government policy, but rather an extension of it. For example, Canada imposed export controls (principally an export tax) on oil even before the 1973 embargo. Similarly, the Crown interest provision ('back-in') established in the NEP was first applied in the mid-1970s, and the fact that the U.S. is only now reacting to such a provision tends to undermine U.S. credibility on the issue.

In his comments John Whalley argues that the NEP issue is characteristic of many other Canada/U.S. trade issues in that Canada has instituted what it views as purely domestic policies, but which in fact have international implications. The most contentious issue with the U.S. in the NEP has been the retroactive provision in 'back in' arrangements that involve changes in the leasing of Crown lands. Whalley feels that these retroactive provisions could have been replaced by changes in taxation policy that would have had similar effects but without perhaps incurring the same adverse U.S. reaction.

In his discussion of Canada-U.S. energy issues, Brendan Quirin evaluates the Canadian NEP and enumerates many of the problems it has raised both for the U.S. and Canada. Quirin feels that the economic distortions created by the NEP have led to needlessly high prices for Canadian energy and have created in the Canadian energy industry an atmosphere antagonistic to foreign investment. Quirin points out that even in the absence of the NEP, Canada already has a great deal of control over the oil and gas industry. The oil and gas reserves of foreign-owned firms are located in Canada, and thus subject to Canadian law. In addition, the Canadian government permanently holds most mineral rights, has licensing control over exploration and production, has control over price, and acquires a major proportion of oil and gas revenues through royalties and taxes. Quirin thus questions whether the NEP has perhaps been an unnecessary policy development even from a Canadian government perspective.

Moroz on Canada/U.S. auto trade

In his paper on Canada/U.S. auto trade, Andrew Moroz outlines the factors that led to the signing of the Automotive Products Trade Agreement (APTA) in 1965. He goes on to examine subsequent changes in the North American auto market which have made the APTA a somewhat less-than-satisfactory agreement today. Relatively low market growth rates, direct international competition (primarily from Japanese producers) and the necessity of structural adjustments in production (due principally to the rising price of gasoline) have all combined to alter radically both the automobile industry in North American and the Canada/U.S. automotive-trade relationship. Canada and the U.S. now find themselves competing for automotive industry investment both by foreign companies and by U.S. producers. Moroz feels that, while both countries would like to renegotiate the APTA, the objectives each would seek would be diametrically opposed.

In his comments, Thomas Atkinson argues that U.S. automobile manufacturers feel that the APTA has worked well. He thinks that the real concern to the North American auto industry is that both the United States and Canada could lose the advantages of the APTA because of the Tokyo Round tariff reductions, competition from Japanese auto manufacturers and potential 'local content' legislation in the U.S.

Bernard Ostry (in remarks delivered by Roger Hill) notes that Ontario has a special interest in the well-being of the Canadian auto industry because 80 per cent of Canadian automobile output originates in Ontario. Ostry is concerned that while the Canadian government has addressed the problem of Japanese automobile export diversion into Canadian markets due to U.S. import restraint policies, no effective measures have been instituted for the more significant problem of protecting North America as a whole from Japanese diversion to U.S. and Canadian markets due to particularly effective import restraints in Europe.

Boyer on Canada/U.S. transportation issues

In a wide-ranging paper, Kenneth Boyer deals with a number of issues affecting Canada/U.S. transportation. He attributes most of the difficulties in the areas of trucking, aviation, railroads, and shipping to the fact that policy changes by one country have not been met by corresponding changes by the other country. He also emphasizes that the major reason for pursuing deregulation in the transportation industry is that it would increase economic efficiency, and feels that in the U.S., there has been a decisive movement toward establishing efficiency as the sole legitimate goal of policy.

In his comments, Michael Brock agrees with Boyer's position that Canada/U.S. transportation difficulties stem from differences between the countries in regulation policies, but does not feel that adopting the goal of economic efficiency alone would necessarily alleviate these difficulties. Brock points out that the transport industries in the U.S. and Canada have developed in different ways. The Canadian sector, for instance, has evolved in response to the political needs of nation-building and thus as an arm of government, and the U.S. transport sector has developed as a private enterprise system with regulation serving to deal with marketplace activity rather than with broader political concerns. Brock feels that many international transportation problems often result when each country does not understand the purposes regulation serves in the other.

Harold Handerson is largely in agreement with Boyer's position concerning the desirability of achieving economic efficiency in the transport industry. He argues that if better information on the economic impacts of policy changes were made widely available, it would help make such changes more acceptable politically and would thus help improve efficiency in international transportation. Handerson also points out that regulatory changes for one mode of transportation (such as rail) may affect other transport sectors (shipping or trucking, for example) that may be viewed as potential substitutes. Thus the effects of policy changes in any one transport sector must be examined for the industry as a whole.

Bird and Brean on Canada/U.S. tax relations

Richard Bird and Donald Brean, in their paper on Canada/U.S. tax relations, recognize that the United States and Canada (and their states and provinces) may have to deal with conflicting private interests in the area of international taxation, and that international tax treaties are more readily understood in terms of political rather than economic efficiency. They see recent political trends implying that in future, tax systems may become more protectionist, and the authors feel that both countries, but especially Canada, would lose economically from this increased protectionism. And while the impending Canada/U.S. tax treaty will be the world's most critical tax treaty in terms of the number of individuals and firms affected, the United States' domestic policies rather than its international arrangements have greater effects on Canada's welfare.

In discussing the Bird-Brean taxation paper, Lawrence Fox also notes the political nature of tax policy, and points out that such policies have been used by both the Canadian and U.S. governments to influence trade and investment between the two countries. Fox suggests that the Bird-Brean evaluation of the Canada/U.S. tax treaty may have a Canadian bias. For example, Bird and Brean condone Canadian higher taxes on dividends and royalties paid to foreigners in spite of an OECD tax-investment agreement endorsing the principle of equality of treatment, but they condemn the United States' DISC export incentive as illegal under the GATT. Fox also suggests that the Canadian national interest may have changed since tax treaty negotiations were begun 11 years ago. Canada entered negotiations as a capital importer, but has since become a net exporter of capital.

Shorter sessions

Four further papers were also presented at the conference covering topics for which there was not time to devote a whole session. In his paper on subsidy pacts, David Conklin discusses the economic rationale for subsidies (which may include grants, subsidized loans, procurement program and tax concessions). He goes on to investigate the problems involved in establishing international subsidy agreements. Conklin feels that high unemployment and low productivity rates are responsible for much of the current support of subsidies. He also notes that, with current and projected reductions in trade barriers, subsidies will become relatively more important as a trade-determining factor. However, international subsidy negotiations will be much more complex than tariff negotiations, principally because the definition of subsidies is often difficult when government financial assistance can take so many forms. Conklin also points out that reductions of political barriers can serve as an alternative to subsidy pacts.

Alan Rugman presents and analyses a variety of data pertaining to the largest 22 of the U.S. subsidiaries in Canada. These are concentrated in fuels and manufacturing. Subsidiaries are shown to have similar returns as their parents but higher variability. Rugman attributes this greater earnings variability to the relatively smaller size of the Canadian economy and its cyclical sensitivity as well as to the specialized characteristics of many U.S. subsidiaries. Rugman is critical of the Canadian government's policy to establish 'world product mandates', which involves selective R&D subsidies to Canadian subsidiaries in the hope of increasing technology-intensive exports. He finds that the export performance of subsidiaries is roughly the same as that of Canadian-owned multinationals. Subsidiaries do proportionately less R&D than do their parents, but are similar in this regard to Canadian-owned firms. Rugman notes that foreign direct investment in Canada has been fostered by the Canadian tariff and the availability of natural resources for exploitation. Foreign ownership could be reduced accordingly by removing tariffs and by focusing R&D on Canadian-owned firms specializing in resources and services.

James Bradford reviews the Defense Production Sharing Arrangement (DPSA) that was started in 1941 to provide Canadian manufacturers access to the U.S. market for military procurement and thus expand the industrial base for the U.S. Department of Defense (DOD) in meeting defense requirements. The DPSA involves waiver of 'Buy American' regulations, removal of tariffs, and free movement of U.S. defence products into Canada. It is estimated that about 30 per cent of the annual DOD procurement budget is available for competition by Canadian firms. Some 225 Canadian companies were involved in military contracts with the DOD in 1982, with sales in excess of a billion Canadian dollars. U.S. sales of defence items to Canada have been somewhat larger in the past two decades than Canada's sales to the U.S. The Canadian government provides strong support to the DPSA program. The main problem at present concerns limitations on technology transfer from the U.S. to Canadian firms.

In his paper on Ontario's perspective of Canada/U.S. trade issues, Roger Hill argues that economic development in Canada depends on the ability to compete in external markets. For Ontario, the most significant external market is the United States, which accounted for 90 per cent of Ontario's exports in 1983. For Canada as a whole, the United States is still an important market, but it is relatively less important than for Ontario. And while Ontario's considerations in its trade relations with the United States are primarily economic ones, the federal government must also consider diplomatic or strategic issues. Thus, there may be conflicts between Ontario's and Canada's interests in U.S. trade. Hill feels that this conflict is most significant with regard to the Canada/U.S. Automotive Pact. Ontario feels it is not benefiting as it should from the Pact and would like to renegotiate it, but renegotiation must be done at the federal level and federal response to date has not been enthusiastic.

THEMES OF THE CONFERENCE

A number of themes emerged both from the papers themselves and from the discussion at the conference. In this section, we attempt to list these themes and discuss their significance for future developments in Canada/U.S. trade relations.

Conflict and accommodation

While much of the discussion of Canada/U.S. issues in the conference focused on trade and investment policies, there was also discussion of the broader aspects of the relationship (e.g., of whether there should be free trade between Canada and the U.S. or what the form of foreign ownership should be) and many of the more contentious sector-specific issues.

There is no question of the importance of the mutual trade and investment relations which link the U.S. and Canada. As mentioned earlier, over 70 per cent of Canadian trade is with the U.S., while around 30 per cent of U.S. trade is with Canada. Further, over 50 per cent of U.S. foreign investment is in Canada, while 90 per cent of foreign investment in Canada originates in the U.S.

From the U.S. perspective, Canada is perceived to be relatively more interventionist, and at times more prone to adopt policies which may seriously impinge on American interests. In recent years, the U.S. has been pursuing policies aimed at deregulating important sectors such as transportation, banking, and energy, and conflicts have arisen because of stricter regulatory policies in these sectors in Canada that have arisen out of Canada's attempts to maintain sovereignty as well as distinguish itself economically and culturally from the U.S. Canada also differs from the U.S. insofar as its provinces have considerable autonomy, including provincial control of natural resources. In view of the U.S. dominance of Canada's trade and investment relations, important changes in Canadian policies are thus seen able to have a significant impact on U.S. interests.

From Canada's perspective, the U.S. is perceived as taking its economic relations with Canada for granted and to be preoccupied with its relations with Japan, Western Europe, and other countries. In this connection, Canada feels vulnerable since its interests may be damaged by U.S. actions directed against these other trading partners. Further, the U.S. has relied increasingly on administered protection in the past decade, and some complaints have been directed at important sectors in Canada, with potentially detrimental effects.

It is therefore not surprising that there is scope for disagreement and conflict in the economic relations and policies between the two nations. Nonetheless, what is remarkable is that there seems to be a persistent undercurrent of goodwill between the nations and a willingness to pursue mutually beneficial policies of accommodation. In part, this may reflect the fact that Canada has comparatively little leeway in designing independent and efficient national economic policies. There is also a widely shared realization among Canadians that they have derived substantial benefits from their mutual trade and investment linkages with the U.S.

Further, even though the policy process in the U.S. seems unwieldy and at times to cater excessively to special interests, it can be argued that on the whole Canada has not suffered significantly from U.S. trade and investment policies especially given Canada's preferred-market access to the U.S. in a number of areas. Thus, there seems to be a sharp difference between the political discussion of trade and investment frictions between the countries and the situation at an operational policy level where issues are often resolved quietly and with only a limited amount of acrimony.

Bilateral frictions

Current frictions between the U.S. and Canada reflect both broad actions taken, especially by Canada, involving direct foreign investment and energy, and particular actions taken in both countries because of concern over individual sectors. Thus, Canada's Foreign Investment Review (FIR) Act can be viewed as an attempt to define the role of and to monitor new investment initiatives by U.S. and other foreign multinationals in Canada. The NEP has more complex objectives which involve limiting the degree of foreign ownership and control of Canadian resources, the pursuit of energy independence, and the interprovincial distribution of energy rents.

The U.S. has not objected to FIRA and the NEP as such, but rather to the violation of the principle of national treatment and to certain aspects of these policies that are held to be protectionist in intent. The issues here are that the existing rules governing international investment and trade-related investment requirements are not well-defined or binding. Yet it is important that efforts be sustained to develop a clear and effective multilateral framework covering trade and investment relations and policies in order to quell the anarchy that might otherwise occur. Both Canada and the U.S. recognize this need, but Canada's perceived vulnerability to foreign ownership and control may prevent it from wholehearted support of multilateral agreements.

As tariffs have been reduced in successive multilateral negotiations under the GATT, governments have turned increasingly to nontariff interventions to deal with ostensible market disruptions due to imports. The difficulty here is that the criteria for defining disruption and the determination of injury are judgemental and subject to political pressures. Further, the GATT has become ineffective in constraining the use of administered protection, voluntary export restraints in particular. The mechanism of administered (contingent) protection has thus become entrenched in both the U.S. and Canada. Since U.S. trade is more varied globally, the situation can arise that Canada may be adversely affected by a U.S. trade action that is directed at other countries, as in the case of specialty steel. Needless to say, this is a cause for concern in Canada. Canada may also be the object of U.S. trade complaints, although as mentioned above it has thus far been spared any serious restrictive measures undertaken by the U.S.

Means of resolving frictions

A persistent theme running through the conference concerned the efficacy of existing means of resolving frictions between the U.S. and Canada. There was some difference in views expressed with regard to the functioning of existing channels and institutions for resolving conflicts, the possible need for new mechanisms, and the role to be played by informed and experienced officials in the policy process.

Whether to focus trade liberalization efforts on bilateral or multilateral negotiations also received considerable attention, especially in view of the perception that the authority of the GATT has been eroded and that its membership has become so large that its governing principle of rule by consensus is no longer viable. While it is difficult to reach any definitive conclusions on these matters, the present relative harmony in Canada/U.S. relations suggests that existing channels and institutions are functioning reasonably well, even though tensions emerge from time to time.

Future trade negotiations

In negotiating on both current and future trade and investment issues that divide the two countries, a theme that was returned to repeatedly in the conference was how to move forward, particularly on the trade aspects of the relationship, within the current multilateral international framework. To the extent that increasing frustrations have developed with respect to multilateralism in the GATT, the bilateral option has become more attractive for each of the countries. Because Canadian interests are so heavily dominated by Canada's bilateral trade and investment links with the U.S., an increasingly natural route for Canada to follow appears to be to negotiate with the U.S. bilaterally, independent of any multilateral negotiations in the GATT. This thinking is reflected in the recent initiative from the Department of External Affairs in Ottawa to negotiate sectoral free-trade arrangements between the U.S. and Canada involving textiles, agricultural machinery, urban transit equipment, petrochemicals, red meat, and computer services.

These proposals were discussed at the conference along with their implications for multilateralism under the GATT. Proposals for free trade between Canada and the U.S. have been made on several occasions in the past, and it has been stressed that Canada might benefit substantially from such an arrangement. Political considerations make it unlikely that bilateral free trade could be achieved. But the example of the Canada/U.S. Automotive pact suggests that sectoral arrangements are possible. Important questions remain, however. In particular, the U.S. might insist that Canada should modify or eliminate FIRA requirements or some objectionable features of the NEP in return for sectoral free trade agreements. There is also the question of whether bilateral arrangements would be exclusive of and thus possibly detrimental to third countries or whether these arrangements might pave the way to negotiation of more inclusive multilateral arrangements.

CONCLUDING REMARKS

No single conference can hope to cover all aspects of the complex relationship between the U.S. and Canada. Wider aspects of economic policy covering monetary policy, interest rates, and exchange rates were not discussed. Nor were environmental issues, resource questions beyond the NEP (also covering renewable resources such as fisheries), water, transborder broadcasting and telecommunications. Nonetheless, we feel that the central issues concerning trade and investment between the two countries were thoroughly aired in the conference, and are laid out in the papers which follow. We can only hope that in some small way this volume will contribute to the joint and ongoing policy debate on these issues both north and south of the border.

Keynote address

Jake Warren
Bank of Montreal

It remains true that the overwhelming number of Americans have only an uninformed and often distorted view of modern Canada. Meanwhile, Canadians, while having a relatively more informed view of the affairs of their southern neighbour, continue to have a near allergic reaction to many of the actions of the U.S. in fear of an adverse impact. But compared with the earlier postwar period there has been, I believe, a marked improvement and comprehension of the evolving nature of Canada in academic, business, and official circles in the United States. There's still a fair way to go from the Canadian point of view, but the improvement has been substantial nonetheless.

In Canada the national games of second-guessing U.S. policy and southbound blame transference go on as usual. But as the years pass and successive generations of Canadians acquire a fuller measure of maturity, there is, I believe, a growing appreciation that our powerful North American partner is itself not without difficult internal problems, both social and economic; also, that whether U.S. administrations be doveish or hawkish, the role of the United States as *the* Western superpower inevitably carries with it responsibilities and decision-making, often uncomfortable, and certainly different in kind from those of countries like Canada which expect to be consulted but whose views and positions are less critical to the common weal.

With the increase in understanding, and improved media coverage, it is no longer as necessary as it was when discussing Canada/U.S. relations in the past to spend time outlining the differences between the endowments, peoples, linguistic composition, geography, climates, origins, histories, constitution and political systems of the two countries or to explain that between them real differences of perception and national interest indeed arise. Thus, for our purposes this evening, I shall take the following as understood:

- Because of inherent differences and the simultaneous vast interaction between the two societies, there will be a range of problems outstanding at any one time. Some of these problems are likely to be more deep-seated and enduring than others.
- The existence of such a range of outstanding issues does not signify poor health or the qualitative direction in which relations are moving.
- The way in which these differences are perceived in the two countries will depend in part on whether, for recessionary or other reasons, national moods are buoyant and expansive or recessive and protectionist, and on the extent to which the cycles are in or out of synch in the two countries.
- This perception will also be a function of the will of the leadership in the two countries to give the relationship reasonable priority and to make it work. Incidentally, conscious determination so far as possible to avoid confrontation is not incompatible with a measure of nationalist rhetoric necessary from time to time in both countries for domestic political reasons.
- Apart from inherent difficulties, the number of problems is likely to increase and intensify to the extent that the philosophical predilections of governments in the two countries significantly diverge.

This being said, it remains necessary on an ongoing basis to deal with issues as they arise and, normally, one would hope, in ways designed to maximize mutual benefit and minimize unnecessary or avoidable damage to the other country.

This is easy enough to say, but can be very difficult in practice, especially if an issue has become highly politicized in either or both countries and if room for manœuvre has accordingly been narrowed.

In thinking about the management of tensions and frictions, it is useful to keep in mind that the origin and nature of problems can vary enormously and that the process and prescribed treatment for dealing with them should also be expected to vary. For one, sovereignty and jurisdiction can be a very delicate area, even between the friendliest of nations. Where there are interests in common and demonstrably large benefits to all, as in the case of the St. Lawrence Seaway, major breakthroughs requiring some sharing of jurisdiction become possible and local opposition can be overcome. But where interests are competitive, compromises in the area of sovereignty are hard to come by. For problems of this kind, treaty solutions are a possible answer, either international or bilateral. But some issues, such as seaward boundaries, may simply prove non-negotiable and must either be put aside, or, if the matter is not able to be postponed, referred to international arbitration.

Tension can also arise when legitimate action at the border by one or other country can adversely affect the other to an unacceptable degree. Environmental issues come at once to mind. Clearly, established institutional structures such as the International Joint Commission have proven helpful in cases of this kind. However, governments still have to be willing to act in ways that will take account of extraterritorial interests.

Where trade and other economic issues are concerned, a great variety of situations can, of course, be envisaged. The following categories may encompass a reasonable number of the more typical cases:

- where domestic actions, quite legitimate in one jurisdiction, have either an intended or unintended adverse impact in another;
- where actions taken against a third country or countries have spillover effects on the other country;
- where 'national' treatment is seen to be denied, or where expected market access is impaired because of preference mandated for domestic suppliers;
- where differences arise concerning treaty obligations;
- where the assertion of extraterritorial jurisdiction by one country has an adverse impact on economic opportunities legitimately open to the other.

On the political side, differing responsibilities, differing perceptions, and differing reactions deriving from such perceptions can be tension-inducing – the Soviet natural-gas pipeline to Europe, the U.S. roles in Central America and Grenada could be cited as examples. In earlier days, trade with the PRC and Cuba come to mind as issues which basically had political origins.

Ambassador Gottlieb, in his speech to the Empire Club last week referred to three dynamics currently at work in the U.S. with a potential for harming Canada. First, there is the widespread view that the U.S. is not getting a fair deal in other countries. Second, there are institutional differences that give, for example, the United States Senate an important and legitimate role in foreign relations, and, perhaps more importantly for Canada, allow the U.S. Congress in the normal course of its business independently to take specific decisions which also directly or indirectly affect Canadian interests. The third dynamic referred to by Ambassador Gottlieb was the contrasting regulatory environment in the two countries and how such discontinuities can give rise to concern and threats of retaliatory action, particularly in times of change and economic difficulty.

The Ambassador went on to cite three types of legislation that have potential to harm Canada. These are:

- Legislation specifically directed against Canadian interests; examples cited were uranium, trucking, and the import of natural gas.
- Generalized legislation to protect against the trade practices of third countries; examples cited included the Surface Transportation Assistance Act, with its fallout on Canadian exports of steel and cement.
- Domestic legislation not intended to deal with other countries at all, but having impact on Canada; for example, the Clean Air Act.

I have not touched on defence and a number of other areas where Canada and the United States interact heavily. But I hope my comments will still support the conclusion that no simplistic solution, institutional or otherwise, can be expected to manage with any success the broad, complex, and critically important spectrum of our relations with the United States.

I would like to applaud in this context the Canadian government's recognition, in its recent Trade Policy paper (Canada 1983), that successful management of the Canada/U.S. relationship is nonetheless 'fundamental to the achievement of Canada's economic objectives'. Getting our priorities better sorted out is a move that is certainly to be welcomed.

The emphasis in the Trade Policy paper on maintaining an open and constructive dialogue with the United States to improve comprehension and resolve bilateral issues is likewise to be welcomed. I also agree that a radical shift in approach, such as would be entailed in the negotiation of a full free-trade area or customs union, is not a realistic option given present circumstances. I say that with great respect for the logic and consistency with which Ron Wonnacott has urged the case for free trade and for the balance and perception with which his views have been put forward in the paper presented to this conference. Canadians, I believe, are today willing to forgo the optimization of collective economic benefit in order to retain the right themselves to manage the Northern part of this continent. And they fear that the measure of economic interdependence which these options would sooner or later call for would undermine to an unacceptable degree their political freedom of action.

I do not rule out consideration of such options over the longer haul, when Canadian maturity and strength may be such that concerns about vulnerability would be far less than they are now. However, it should still not be assumed that the problems between the two countries would suddenly evaporate under free-trade or customs-union arrangements. While the area of trade vulnerability would certainly contract, particularly if exception from U.S. defences against unfair trading practices could be negotiated, other problem areas would remain.

Now, having finished expressing my reservations about the more dramatic bilateral trade options, may I express my strong support for working closely with the United States to strengthen and improve the multilateral trading system on the one hand, and on the other, for a careful exploration of the possibility of free trade with the United States in certain industrial sectors and in services, for example, as was proposed recently by the Royal Bank for computer services.

On the latter point, as a banker it is not difficult to appreciate how vital to business is the instantaneous transmission of information by electronic means across continents and jurisdictions, around the clock and around the world. Claims to this essential information flow that are of a special-interest or protectionist nature should surely be resisted just as we would resist interference with today's usual information transmission by letter or telephone.

I would also draw attention, as the Royal Bank has done in their proposal, to the need, when looking at sectoral free-trade arrangements either for goods or services, not just to remove tariffs, but to ensure that promised access is insulated from nontariff barriers or like interventions that could rob the arrangement of real meaning in one or another of the markets.

If, as I hope, the sectoral free-trade initiative is carried forward by the two governments, I would expect that the area for negotiation would not be confined only to those sectors where the advantage of sectoral free trade would appear particularly attractive from the Canadian point of view. I assume, or at least hope, that potential U.S. requests for negotiations in other sectors of interest to them have been fully taken into account in the Canadian analysis.

I imagine also that if the sectoral option were to be seriously pursued, priority areas to be addressed in Canada would sooner or later have to include those sectors of particular interest to the West and to the Maritime provinces – for example, forest and fisheries production.

If in sectoral negotiations one is prepared to remove remaining tariff barriers, deal adequately with nontariff barriers, and have trade take place away from the reach of safeguard measures at least in normal circumstances, then one or other side may wish to carry the matter a step or two further and ask for assurance of roughly equal access to supplies at comparable costs, including, for example, material and energy costs. The problems associated with such a step would, I believe, be indicative of those that would be encountered, albeit in a much bigger way, if the more radical options of a free-trade area or customs union were to be pursued in depth.

Improved access to the U.S. market and willingness to pay for it will remain important for Canada whether access is achieved via the multilateral route or through a sectoral approach. Regarding the former approach, major world-trade negotiations could span a number of years, so we shouldn't hold our breath for early solutions in this sphere. However, we can be sure that things will not stand still. These days there is really no such thing as the status quo. Deals get made whether or not they are in line with a strict interpretation of the GATT. Rules get bent, new practices spring up, exchange rates get out of line, the mix of production and trade changes, and the process of adaptation proceeds unequally in industrial and nonindustrialized countries alike.

In such a time it seems to me that the U.S. and Canada should takethe lead in resisting and reversing protectionism and endeavouring to head the world trading environment towards an eventual multilateral negotiation. At the same time, as I have said, we should be bilaterally exploring what can be done by way of trade liberalization between our two countries, within the limits of what proves economically negotiable and politically acceptable. I would favour a sort of progressive adjustment of the current post-Tokyo Round framework, a process that might open up wider possibilities as time went on. Such an approach would appear to have a number of advantages:

1 It would engage the U.S. and Canadian authorities in a positively oriented trade negotiation that would of itself serve to ward off to some degree any potentially damaging protectionist pressures.

2 Such a constructive engagement would in turn tend to impart a more positive tone to the rhetoric of political leaders on both sides of the border.

3 It would permit a gradual and 'learning-by-doing' approach to the resolution of nontariff and safeguard issues between the two countries. Such an approach, in addition to benefiting the sector concerned, could reveal both avenues of understanding that might prove applicable over a broader area and the contemporary limits of political tolerance for whatever degree of economic integration may be found desirable in the course of negotiations.

4 Perhaps most importantly, an incremental sector-by-sector approach would not be irreversible, and the process would not expose the two governments to the fallout associated with potential failure of more ambitious negotiations.

5 It may be argued that this progressive step-by-step approach, in which the end result is hidden in the future, would create undue uncertainty for direct investment. While a valid concern, it is present also in unmanaged adjustment of the status quo. And at least in the sectors concerned, the investment framework would be known following successful negotiations. Looking further ahead we may hope that eventual further progress in multilateral tariff reduction, the evolution and extension of codes and clarification of GATT rules on safeguards would improve investment certainly between the two countries in areas not covered by special sectoral negotiations.

In envisaging a sectoral approach with the United States the issue of external most-favoured-nation (MFN) obligations needs to be considered. That these would set some constraints on what might be negotiated between Canada and the U.S. seems to me natural and desirable. The balance of rights and obligations established over the years with other important trading partners should not be haphazardly or unnecessarily disturbed by either country.

It follows that third countries' interests should be kept closely in mind as the choice and structure of possible arrangements for sectoral free trade are determined. And such structures would be expected to vary from case to case. Conceptually, some sectors or subsectors might be found where tariff removal and restraint in the application of nontariff and comparable measures could be extended to other trading partners immediately, or over time without serious consequences for either of the bilateral partners. In other cases, arrangements might take a conditional MFN or 'open-ended' character. Further, some situations might suggest that formal exceptions should be sought from the normal rules of GATT. Indeed, compensation could be considered if the foreseen benefits significantly outweighed the estimated international costs.

While as an old GATT hand I hate to contemplate further erosion of the MFN principle, as a realist I must recognize how substantially its writ has already been narrowed. We do live in an imperfect world. If eventual arrangements between the two countries were to fall somewhat short of what is contemplated under the relevant GATT articles, the situation would hardly be unique, considering the many special trading arrangements around the world that have been elaborated with or without the endorsement of the Contracting Parties.

Whatever the future may eventually hold for the framework of Canada/U.S. economic relations, the years ahead will undoubtedly continue to be very active on the bilateral front. Problems will continue to arise, national moods will vary in warmth and mutual confidence and, as in the past, genuine differences of national interest will emerge that will have to be accepted as such.

Getting the best out of the relationship within whatever general framework may be in place will continue to require good management and good housekeeping. It will also require a willingness to accept that decisions or actions taken in one country might have a negative impact in the other.

Now a word about the institutional aspects of relationship management. My points on this subject are as follows:

- If the will to make the relationship work is present and the habit of doing so ingrained, almost any reasonable set of established arrangements for consultation and problem-solving are likely to work quite well with the dispute areas accordingly minimized.
- Such a happy state of affairs cannot, however, be counted on as a continuing feature, given that governments and administrations come and go, legislative personalities constantly change, and that experienced diplomats and other civil servants also switch their assignments.
- This being so, the institutional arrangements supplementary to government channels should be such as to reinforce dispositions towards the avoidance of difficulties and to inhibit tension. Accordingly, their design should include or at least facilitate advance consultation whenever possible, their terms of reference should be oriented to early identification of potential difficulties and to problem solving. If possible, such institutions also should be manned by experienced, knowledgeable, and creative people who can see the various problems in perspective and at the same time be innovative in addressing new situations and difficulties.
- When I speak of institutions, I have in mind consultative arrangements, committees, and other ways of addressing problems and securing co-operation in their resolution. I strongly believe that such mechanisms should provide room for inputs from and, where appropriate, participation by provinces, as well as affected elements of the private sector.

Before concluding, a word about public versus private diplomacy from the Canadian point of view: here, the test should be effectiveness. In dealing with a relationship so vast and so important as that with the United States, both techniques are undoubtedly called for, depending on the nature of the problem; this would, of course, include the development of a more sophisticated relationship with the U.S. Congress, as discussed on so many recent occasions by Ambassador Gottlieb. I would like to make four observations on this issue. First, the Congressional game must be played very skilfully and with full awareness of possible future linkages and costs. Second, such possible linkages and costs can probably be minimized to the extent that American power centres or groupings that identify with particular or general Canadian interest are the ones that bring direct influence to bear on the Congress rather than the Canadian authorities or affected Canadians themselves. Third, in endeavouring to take advantage of the Congressional route, great care should be taken to avoid or minimize any alienation of the Administration. Finally, I believe we should always bear in mind the great difference between our cabinet system of government and the executive/congressional system in the United States and note that how Canadian authorities relate to the Congressional decision-making process in Washington can have important implications for how U.S. authorities may seek to advance their interests here in Canada at both the federal and provincial levels.

As a last point, I would like to draw attention to the policy proposal published by the Canadian-American Committee at the end of 1981 on the consultative process between the two countries which, it seems to me, has some wise things to say about ways of trying to deal with economic issues. What that report suggests – the need for early warning on problem issues, objective factfinding and analysis, focal points for the consideration of Canada/U.S. problems within each government, and appropriate interface with provinces, legislatures, and the private sector on particular issues – still seems valid to me today, not as a stand-alone system, but as part of the needed instrumentation and institutional structure to which I have referred. I apologize for this commercial, but as some of you may know, Bill Eberle and I were both deeply involved in the preparation of that report and I have to admit to some pride of authorship.

To return again to Alan Gottlieb, in his speech last week he referred to our southern frontier as the longest undefended platitude in the world. References to the undefended border may indeed be platitudinous, but what happens along and across that border never will boring be. Change and challenge will continue to be the order of the day. And while the process of industrial adjustment may have negative implications for employment in a number of sectors of the North American economy, it is clear that prospects for full employment for specialists in Canada/U.S. relations can be expected to remain bright!

I thank you for inviting me and for giving me yet one more opportunity to be with practising members of the community of those dedicated to the understanding and improvement of economic relations between our two countries.

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Canada/U.S. trade and investment frictions: the U.S. view[1]

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INTRODUCTION

Since 1980 especially, there has been a marked increase in frictions between the U.S. and Canada arising from national policy actions affecting bilateral trade and investment. The U.S. has become concerned especially by Canada's introduction of the National Energy Program (NEP) in October 1980 and the more stringent imposition by the Foreign Investment Review Agency (FIRA) of trade-related performance requirements on U.S. firms seeking approval of new direct foreign investment in Canada. The Canadian concerns have been centered around the U.S. system of 'contingent' protection which has been directed at important sectors of Canada's export trade. My purpose in this paper is to review the foregoing and other significant sources of bilateral frictions and to analyse the range of policy options available to reduce or remove these frictions. Most of the discussion reflects a U.S. view, although this is by no means an endorsement of official U.S. positions and policies.

In order to provide some perspective on the various issues, some factual information is presented on the composition and geographic distribution of each country's merchandise trade, services, and direct foreign investment, followed by a discussion of the implications of the size asymmetries between the U.S. and Canada, and some comments on differences in attitudes towards intervention. The various sources of trade and investment frictions that exist currently are then considered – these include FIRA, the NEP, and a variety of sectoral issues. Finally, I discuss the policy options that are available for responding to frictions, and then make some brief conclusions.

SOME SALIENT CHARACTERISTICS OF CANADA/U.S. TRADE AND INVESTMENT RELATIONS

Before considering the various current bilateral trade and investment frictions between the U.S. and Canada, it may be useful to review briefly some important features of the economic relations of the two nations with each other and the rest of the world. Accordingly, I examine below the composition and geographic distribution of each country's merchandise trade, services, and direct foreign investment. I then consider the implications of the size asymmetries between the two countries as they are manifested in the formulation and impact of national policies. Finally, I discuss differences in national attitudes and policies towards government intervention and the increased use of 'contingent' protection in the U.S. especially.

The composition and geographic distribution of merchandise trade and services

It is evident from the last line of Table 1 that Canada accounted for about 16 per cent of total U.S. merchandise exports and imports in 1981. This was down noticeably compared to 1973, indicating a significant increase in U.S. trade especially with the oil exporting countries and other developing countries. According to Table 2, the U.S. accounted for about two thirds of Canada's total trade in 1981, which was a slightly lower share than in 1973. If we consider the composition of bilateral trade, manufactures were 84 per cent (U.S. $30.1 billion) of U.S. exports to Canada and 60 per cent (U.S. $26.4 billion) of imports from Canada in 1981. Comparing bilateral with total trade, U.S. trade with Canada was concentrated relatively more on manufactures, especially on the export side. This was the case as well for Canada, although it is noteworthy that primary products accounted for 40 per cent (U.S. $17.8 billion) of Canada's bilateral exports to the U.S. and nearly half of its total exports in 1981.

The data on the composition of trade in Tables 1 and 2 provide further insight into each nation's 'revealed' comparative advantage. Thus, according to Table 1, in 1981 the U.S. had net imports from Canada in primary products and semimanufactures and net exports of engineering products and consumer goods. (Looking at total trade, the U.S. pattern of trade is much more varied globally than it is bilaterally with respect to Canada.) Using Canadian data in Table 2,

TABLE 1
United States merchandise trade by Commodity Groups, 1973 and 1981 (billions of U.S. dollars: exports F.O.B., imports C.I.F.)

		Canada			Total merchandise trade		
Commodity group	Year	Exp.	Imp.	Bal.	Exp.	Imp.	Bal.
1 Primary products	1973	2.2	7.0	−4.8	24.8	27.3	−2.5
	1981	5.9	17.4	−11.5	68.4	123.2	−54.8
2 Semi-manufactures	1973	1.9	2.6	−0.7	9.8	10.7	−0.9
	1981	5.1	9.0	−3.9	35.3	35.1	0.2
3 Engrg. products	1973	9.3	7.5	1.8	29.2	25.6	3.6
	1981	22.7	16.0	6.7	103.0	81.5	21.5
4 Consumer goods	1973	0.9	0.5	0.4	3.5	8.7	−5.2
	1981	2.3	1.4	0.9	11.9	26.6	−14.7
Total mfs. (2-4)	1973	12.1	10.6	1.5	42.5	45.0	−2.5
	1981	30.1	26.4	3.7	150.2	143.2	7.0
Total trade	1973	14.3	17.6	−3.3	67.3	72.3	−5.0
	1981	36.0	43.8	−7.8	218.6	266.4	−47.8
Area, %	1973	21.2	24.3		100	100	
	1981	16.5	16.4		100	100	

SOURCE: Adapted from GATT, *International Trade 1981/82*, Table A19.

the results are broadly the same, although there are some differences which may be attributed to the CIF valuation of imports by the U.S. as well as differences in classifications used in the two countries.

Receipts and payments on merchandise trade and services by category are shown for the U.S. and Canada for 1973 and 1981 in Tables 3 and 4. U.S. net receipts of investment income from Canada were substantial in 1981 and more than offset the U.S. deficit on bilateral trade with Canada. (This was the case also for the U.S. with respect to the other industrial countries and the rest of world comprising OPEC, other developing countries, and the socialist countries.) In 1981, Canada's net payments for interest and dividends and other services more than offset its merchandise trade surplus. The bulk of these net service payments went to the U.S.

TABLE 2
Canadian merchandise trade by Commodity Groups, 1973 and 1981 (billions of U.S. dollars: exports F.O.B.)

		United States			Total merchandise trade		
Commodity group	Year	Exp.	Imp.	Bal.	Exp.	Imp.	Bal.
1 Primary products	1973	7.1	2.2	4.9	13.1	4.7	8.4
	1981	17.8	7.4	10.4	32.5	16.2	16.3
2 Semi-manufactures	1973	2.4	2.0	0.4	3.2	2.9	0.3
	1981	8.9	5.4	3.5	12.2	8.1	4.1
3 Engrg. products	1973	7.1	10.9	−3.8	8.2	13.0	−4.8
	1981	16.8	27.8	−11.0	21.0	33.6	−12.6
4 Consumer goods	1973	0.4	1.2	−0.8	0.6	2.4	−1.8
	1981	0.9	2.9	−2.0	1.5	5.5	−4.0
Total mfs. (2-4)	1973	9.9	14.1	−4.2	12.0	18.3	−6.3
	1981	26.6	36.1	−9.5	34.7	47.2	−12.5
Total trade	1973	17.0	16.3	0.7	25.1	23.0	2.1
	1981	44.4	43.5	0.9	67.2	63.4	3.8
Area, %	1973	67.7	70.9		100	100	
	1981	66.1	68.6		100	100	

SOURCE: Adapted from GATT, *International Trade 1981/82*, Table A20.

The composition and geographic distribution of direct foreign investment

It can be seen in Table 5 that, in 1981, mining and petroleum accounted for 30 per cent of U.S. direct foreign investment in Canada, manufacturing for 42 per cent, and trade, banking, finance, insurance and real estate, and other industries the remaining 28 per cent. Petroleum accounted for 13 per cent of Canadian direct foreign investment in the U.S. in 1981, manufacturing for 47 per cent, and trade, etc., for 40 per cent. Overall, 21 per cent of U.S. direct foreign investment was in Canada in 1981 and 14 per cent of foreign investment in the U.S. was accounted for by Canada.

The data for Canada's direct foreign investment are presented for 1973 and 1978 in Table 6. Since the system of classification and terminal years differ, comparisons cannot be made directly with the

TABLE 3
Receipts and payments on merchandise trade and services for the United States by category, 1973 and 1981 (billions of U.S. Dollars)

		Canada			Total trade		
Category	Year	Rec.	Pay.	Bal.	Rec.	Pay.	Bal.
1 Mdse., ex. military	1973	15.6	17.2	−1.6	70.3	69.8	0.5
	1981	46.0	48.3	−2.3	237.0	265.1	−28.1
2 Military transfers under sales contracts	1973	0.1	0.2	−0.1	2.4	4.6	−2.2
	1981	0.1	0.1	0.0	9.7	11.1	−1.4
3 Travel	1973	1.1	1.2	−0.1	3.3	5.4	−2.3
	1981	2.7	2.1	0.6	12.2	11.5	0.7
4 Passngr. fares & other transp.	1973	0.4	0.3	0.1	5.3	5.9	−0.6
	1981	0.8	0.6	0.2	15.6	16.9	−1.3
5 Fees and royalties	1973	0.5	0.1	0.4	3.6	0.4	3.2
	1981	1.0	0.3	0.7	7.3	0.7	6.6
6 Other private/govt. services	1973	0.3	0.3	0.0	2.2	1.9	0.3
	1981	0.6	0.4	0.2	6.6	5.1	1.5
7 Invstmt. income	1973	2.3	0.7	1.6	14.0	8.7	5.3
	1981	10.2	2.3	7.9	86.2	52.8	33.4
Total services (3-7)	1973	4.6	2.6	2.0	28.4	22.3	6.1
	1981	15.3	5.7	9.6	127.9	87.0	40.9
Total mdse. & services (1-7)	1973	20.2	19.8	0.4	101.0	96.7	4.3
	1981	61.4	54.1	7.3	374.6	363.1	11.5
Area, %	1973	20.0	20.5		100	100	
	1981	16.4	14.9		100	100	

SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, June 1983, 39, 60-2, and March 1975, 34, 42-5.

U.S. data in Table 5. In any event, the data indicate that more than half of Canadian direct foreign investment abroad was in the U.S., and the U.S. accounted for about 80 per cent of the total in Canada. Further industry detail is provided in Table 7, which distinguishes between foreign ownership and control by the U.S. and other countries for 1977. It can be seen that U.S. ownership and control of capital were 40 per cent in mining and smelting, 42 and 51 per cent in petroleum and natural gas, and 39 and 42 per cent for all manufacturing. While the details for some of the sectors within manufacturing are not given in order to prevent disclosure, the dom

TABLE 4
Receipts and payments on merchandise trade and services for Canada by category, 1973 and 1981 (billions of Canadian dollars)

		United States			Total trade		
Category	Year	Rec.	Pay.	Bal.	Rec.	Pay.	Bal.
1 Mdse., ex. military	1973	17.3	16.1	1.2	25.5	22.7	2.8
	1981	56.5	52.8	3.7	84.5	77.1	7.4
2 Travel	1973	1.2	1.1	0.1	1.4	1.7	−0.3
	1981	2.5	3.2	−0.7	3.8	4.9	−1.1
3 Freight & shipping	1973	0.8	0.8	0.0	1.5	1.6	−0.1
	1981	2.0	2.3	−0.3	4.3	3.9	0.4
4 Other services	1973	0.8	1.8	−1.0	1.5	2.6	−1.1
	1981	2.4	7.9	−5.5	6.3	12.5	−6.2
5 Interest & dividends	1973	0.5	1.7	−1.2	0.8	2.1	−1.3
	1981	0.9	5.9	−5.0	1.8	8.5	−6.7
Total ex. mdse.[a] (2-5)	1973	3.4	5.5	−2.1	6.3	9.0	−2.7
	1981	8.3	19.6	−11.3	19.2	32.3	−13.1
Total mdse. & services (1-5)	1973	20.8	21.6	−0.8	31.8	31.7	0.1
	1981	64.8	72.4	−7.6	103.7	109.5	−5.8
Area, %	1973	65.4	68.1		100	100	
	1981	62.4	66.1		100	100	

a Includes total service and transfer receipts: includes statistical discrepancy.
SOURCE: Statistics Canada, Balance of Payments Division, *Quarterly Estimates of the Canadian Balance of International Payments*, First Quarter 1983, 35, 37, 39, and First Quarter 1976, 96, 100, 104, 108, 112 and 120.

inating presence of U.S. interests is nonetheless quite apparent in all of the manufacturing sectors noted, except iron and steel mills. For all sectors combined, U.S. ownership and control were 40 and 44 per cent.

Implications of size asymmetries

The preceding data and discussion amply demonstrate Canada's importance to the U.S. in terms of its trade and direct foreign investment. But the fact remains that the bulk of U.S. trade and investment takes place with other countries and regions in the world. From Canada's standpoint, however, the U.S. occupies a dominant

TABLE 5
United States direct foreign investment position by industry, year-end 1973 and 1981 (billions of U.S. dollars)

		Canada				
Industry	Year	Abroad	%	U.S.	%	Bal.
Mining	1973	2.7	10.4	n/a	n/a	n/a
	1981	3.4	7.2	n/a	n/a	n/a
Petroleum	1973	5.3	20.8	0.4	10.1	4.9
	1981	10.7	22.8	1.5	12.7	9.2
Manufacturing	1973	11.8	46.0	2.3	55.2	9.5
	1981	19.7	41.9	5.8	47.4	13.9
Trade	1973	1.6	6.3	0.6	14.7	1.0
	1981	4.1	8.7	1.3	10.5	2.8
Banking, finance, insurance & real estate	1973	2.8	10.8	0.4	8.9	2.4
	1981	6.8	14.5	1.7	14.0	5.1
Other industries	1973	1.4	5.6	0.5	11.0	0.9
	1981	2.3	4.9	1.9	15.4	0.4
All industries	1973	25.5	100	4.2	100	21.3
	1981	47.0	100	12.2	100	34.8
Area, %	1973		25.2		20.4	
	1981		20.7		13.6	

n/a Not available separately, or negligible.
SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, August 1982, 22 and 37; and U.S. Department of Commerce, Bureau of Economic Analysis, *Selected Data on U.S. Direct Investment Abroad, 1950-1979*, Feb. 1982, 24.

position as an outlet for exports and source of imports and direct foreign investment. Given the size asymmetries between the U.S. and Canadian economies and the broader involvement of the U.S. in the world economy, there are some important implications worth noting with regard to the formulation and impact of national policies in the two countries.

Thus, for example, Canada is much more affected by macroeconomic developments and policies originated in the U.S. than vice versa. Canada may therefore be limited in its ability to conduct independent policies for domestic purposes, especially when financial and real capital are so highly mobile between countries and exchange rates are flexible. Many of these same considerations apply as well to

TABLE 6
Canada's direct foreign investment position by industry, year-end 1973 and 1978 (billions of Canadian dollars)

		United States				
Industry	Year	Abroad	%	Can.	%	Bal.
Mining & smelting	1973	0.3	6.6	3.1	12.0	−2.8
	1978	0.8	8.8	3.2	8.3	−2.4
Petroleum & natural gas	1973	0.7	17.5	6.8	25.8	−6.1
	1978	1.6	18.1	8.9	23.2	−7.3
Manufacturing	1973	2.1	54.6	11.1	42.4	−9.0
	1978	4.6	51.6	17.6	45.9	−13.0
Merchandising	1973	0.2	4.5	1.6	6.3	−1.4
	1978	0.4	4.0	2.9	7.5	−2.5
Utilities	1973	0.4	10.9	0.5	1.8	−0.1
	1978	0.5	6.0	0.6	1.5	−0.1
Financial	1973	0.1	3.4	2.2	8.6	−2.1
	1978	0.8	9.3	3.7	9.6	−2.9
Other industries	1973	0.1	2.5	0.8	3.1	−0.7
	1978	0.2	2.2	1.5	4.0	−1.3
All industries	1973	3.9	100.0	26.1	100.0	−22.2
	1978	8.9	100.0	38.3	100.0	−29.4
Area, %	1973		50.1		79.5	
	1978		54.7		79.5	

SOURCE: Statistics Canada, Balance of Payments Division, *Canada's International Investment Position, 1978*, 50, 52, 82, and 84.

microeconomic policies affecting trade and investment. Thus, for example, U.S. actions to restrict imports of specialty steel during 1983 were aimed primarily against government steel subsidies in certain member countries of the European Economic Community (EEC). Yet Canada may be affected adversely even though its exports are not subsidized. Thus, Canada may find its economic interests damaged by U.S. policy actions in cases when it is, so to speak, an innocent bystander.

The size asymmetries may have further implications with respect to intergovernmental reactions to each other's policies. Thus, if Canada perceives that its interests are damaged by some U.S. action, it may work through official channels to moderate the adverse effects involved.[2] It might also consider retaliatory action against the U.S., but this seems a less plausible option if the object is to force the U.S. to

TABLE 7
Ownership and control of Canadian mining and smelting, petroleum and natural gas, and manufacturing industries, year-end 1977 (percentage)

	% of capital employed owned in			% of capital employed controlled in		
Industry	Canada	U.S.	All other	Canada	U.S.	All other
Mining & smelting	48	40	12	47	40	13
Petroleum & natural gas	48	42	10	36	51	13
Manufacturing	52	39	9	46	42	12
Beverages	70	21	9	71	n/a	29[a]
Rubber	25	n/a	75[a]	1	n/a	99[a]
Textiles	71	23	6	66	24	10
Pulp and paper	50	39	11	58	31	11
Agricultural machinery	43	n/a	57[a]	42	n/a	58[a]
Automobiles and parts	8	n/a	92[a]	3	n/a	97[a]
Transportation equipment	62	29	9	53	32	15
Iron and steel mills	91	7	2	98	n/a	2[a]
Aluminum	48	41	11	n/a	n/a	n/a
Electrical apparatus	35	56	9	29	60	11
Chemicals	42	46	12	31	55	14
Other manufacturing	53	38	9	40	44	16
All industries	50	40	10	43	44	13

a Data not separately available for the U.S. in order to avoid disclosure.
SOURCE: Statistics Canada, Balance of Payments Division, *Canada's International Investment Position, 1978*, 117.

alter its policy. If the U.S. perceives some damage because of a change in Canadian policy, it can also pursue a diplomatic resolution or consider retaliatory action. In the latter instance, the potential cost to Canada might be sufficiently large to force a change in policy. However, it is by no means obvious that the U.S. could design an effective retaliatory policy without at the same time imposing costly side effects domestically or internationally with respect to other countries.

Attitudes towards intervention and constraints on national policies

The scope and character of government intervention clearly depends on the ideology that guides the political party in power, its ability to harmonize the interests of different domestic constituencies, and the extent to which the interests and possible reactions of other governments need to be considered. While it is difficult to make comparisons between countries, Canada is perceived as being more inclined towards intervention than the U.S., especially under the Reagan Administration. This perception may stem from the relatively higher Canadian tariffs historically, the strength of provincial governments in the federation overall, and from such major actions as the FIR Act, which is viewed especially in the U.S. as discriminatory, and some features of the NEP which are considered to be confiscatory.

Numerous examples of U.S. intervention can of course be cited, including instances in which foreign rights of establishment and ownership have been constrained or prohibited.[3] Typically these interventions are justified by arguments involving public goods, although there may well be cases (e.g., merchant shipping) in which protection is the major motivation. By the same token, there are also prominent examples of U.S. deregulation in such important sectors as airlines, surface transportation, financial institutions, energy, and telecommunications. These actions are designed to moderate or eliminate intervention domestically. Problems may arise, however, if foreign regulations remain intact at the same time that deregulation alters the environment and incentives governing international trade and investment.

Governments are naturally sensitive to changes in political and economic currents at home and abroad, and it is common for policies and administrative procedures to be altered in response to changing conditions. For example, personnel changes were made in the Canadian cabinet and in the direction of FIRA in 1982 which have resulted in a much less strident approach to direct foreign investment and a noticeable increase in the rate of approval of applications. These changes were made apparently in recognition of the criticisms of FIRA which had been expressed by business executives in both Canada and the U.S., by the heads of some provincial governments who viewed foreign direct investment as beneficial to regional growth and employment, and by U.S. government officials. The severe recession affecting Canada and the prospect of a federal election in 1984 were no doubt major contributing factors in making these changes. While the NEP is still very much in place, with its 'back-in' and discriminatory incentive payments provisions intact, the decline in energy prices and the financial difficulties being experienced by Canadian energy firms have certainly altered the premises on which the policy was based and dimmed the enthusiasm for foreign takeovers. It would not be surprising therefore to see some fundamental changes in the NEP especially after the forthcoming election.

One final and important point relates specifically to international trade policy. This involves what Grey (1982, 452) has called the rise of 'contingent' protection, which refers to the increased use of nontariff measures and a corresponding shift away from tariffs as the focal point of trade policy. The resulting system is much more legalistic and yet more discretionary, with protection being imposed under certain conditions as defined by law and subject to the interpretation of the domestic investigatory bodies. Many of the changes in trade policy in the U.S. reflect the increasing influence of the congress. This was especially evident during the Tokyo Round negotiations and in the drafting and approval of the various codes and legislation governing dumping, countervailing duties, and unfair trade practices. Further, as Baldwin (1983) has noted, even though the Reagan administration has paid lip service to a policy of freer trade, it has encouraged fairly strict enforcement of U.S. trade laws. The motivation has at times been to force changes in foreign government trade policies, but there has been significant protectionist pressures as well which the Reagan administration felt compelled to oblige. It is of course difficult to chart the future course of trade actions, but the system of contingent protection is very likely to continue generating frictions in Canada/U.S. trade relations. This is not to say, however, that U.S. trade actions will turn out to be detrimental to Canada since the administrative process may function to defuse protectionism rather than necessarily reinforce it.

CURRENT CANADA/U.S. TRADE AND INVESTMENT FRICTIONS

Having reviewed some of the important features of Canada/U.S. trade and investment relations, I shall now consider the various sources of friction that exist currently. The focus will be particularly on FIRA, the NEP, and certain sectors in which bilateral frictions have arisen. This selection is not intended to exhaustive, however, and I will not deal with such other bilateral issues as acid rain and other environmental matters, a number of aspects of energy policies, boundary claims, fishing regulations, and defense.

Foreign Investment Review Agency (FIRA)[4]

Canada's reliance on direct foreign investment in its resource and manufacturing industries was documented above, especially in Table 7. While such investment may have contributed importantly to Canada's economic performance and welfare, there has nonetheless been concern about possible detrimental effects as well. For example, as Dewhirst (1982) has noted:

> the operations of many foreign-controlled branch plants have been characterized by low levels of research and development, export limitations, and short, inefficient production runs. Moreover, such companies often rely to a large extent on imported technology, resulting in a lack of capacity to develop and undertake the kind of innovation needed to develop products capable of meeting intense competition from other countries in both domestic and international markets.
> Many of the costs associated with foreign ownership stem from the 'truncated' nature of many of these enterprises; that is, key activities are often performed abroad by the parent or some other affiliated firm. One result is that Canadians have been denied the opportunity to develop the skills or capacities that are needed to support and develop internationally competitive businesses. Foreign-controlled subsidiaries also tend to import components and sub-assemblies rather than utilize competitive Canadian supplier industries, thus inhibiting the development of those industries in Canada. (52-3)

One might take issue with many or all of the assertions contained in the foregoing quotation, but to do so is beyond the scope of the present effort. These assertions are nonetheless important because they are indicative of the forces that underlie the Foreign Investment Review Act of 1973. According to Dewhirst (1982):

> The Act establishes the basic principle that new foreign direct investment must bring significant net benefits to Canada, as well as to the investor and the home country. It prescribes

how those benefits are to be assessed by defining five assessment criteria. They are as follows:

1 The effect of the investment on economic activity in Canada, including employment, resource processing, the sourcing of materials, parts and services produced in Canada, and exports;
2 the effect on Canadian participation;
3 the effect on productivity, industrial efficiency, technological development, product innovation and variety;
4 the effect on competition; and
5 the compatibility with national industrial and economic policies of the province or provinces significantly affected. (54)

The right of Canada to screen new foreign direct investment in the national interest is conceded by the U.S. But what concerns U.S. authorities is that the FIR Act may be administered in a protectionist manner and that it is in contravention of Canada's obligations under the OECD Investment Declaration of 1976 and the Articles of Agreement of GATT. The principle of national treatment, which is that foreign firms will be accorded the same rights and obligations as domestic firms in like situations, is the basis of the OECD Investment Declaration. It is important to note that Washington and Ottawa apparently have different perceptions concerning Canada's obligations under the OECD Declaration. McCarthy (1982, 62) has noted that, while Canada had some reservations about the Declaration, the presumption was that their investment policies would nonetheless conform to it. At the same time, the official Canadian view is that they reserved the right to depart from national treatment in certain circumstances. In any event, when the FIRA process became more restrictive beginning in 1980, the U.S. objected to the numerous and legally enforceable requirements being imposed on U.S. firms that were believed to be discriminatory. These included local-content requirements, export commitments, requirements to hire specific percentages of Canadian management and labour, obligations to move production facilities to Canada, and obligations to transfer technology and patents to Canada without charge. The U.S. was also concerned about the possible extraterritorial extension of the FIRA process to the review of mergers involving foreign companies which might cause a change in the ownership of a Canadian subsidiary.

When bilateral consultations concerning Canada's foreign investment review process reached an impasse, the U.S. initiated a GATT action in January 1982, requesting consultations under Article 22 with regard to the Act's local-content and export-performance requirements. When these latter consultations turned out to be inconclusive, the U.S. then invoked the disputes-settlement procedure under Article 23. The U.S. contended that the local-content requirements were in violation of GATT Article 3 concerning national treatment of imports and Article 17 relating to the application solely of commercial considerations to government measures affecting trade. The export requirements were purportedly in violation of Article 17. In July 1983, a GATT panel concluded that the local-content requirements were in violation of GATT, but that the export requirements were not covered under GATT. This case is being considered for final recommendations by the governing Council of GATT.

It was mentioned earlier that the FIRA review process has been greatly expedited, following the appointment of a new Cabinet minister and director of the Agency with a more liberal attitude towards foreign direct investment. FIRA is thus presently much less of an irritant in Canada/U.S. relations than formerly. As previously noted, this change in direction may reflect a variety of factors brought to bear on the Canadian Government in a time of recession, including pressure from the business community in both Canada and the U.S., provincial government pressures to encourage growth and employment, and the efforts of the U.S. Government through various official channels.

Whether the current calm will continue is difficult to say. Much will depend upon the attitudes and objectives of the Canadian government and its leaders. There is always the risk that FIRA procedures can be tightened once again. Thus, so long as the FIRA continues to operate, some firms which might otherwise consider direct investment in Canada may choose not to do so because of the costs and delays involved and the reluctance to adhere to FIRA mandates which are legally enforceable and monitored to insure compliance. Moreover, since the Agency is not required to reveal the reasons for its decisions, firms may have no recourse if their application is not approved. It may be useful therefore for the U.S. to review the possible alternative responses to FIRA decisions that may be detrimental to U.S. interests. I shall return to this below.

National Energy Program (NEP)

The NEP, which was initiated in October 1980, sought to achieve security of energy supply, Canadianization of the oil and natural gas industry, and equity in pricing and the sharing of revenues between the provincial and federal governments. There were several motives underlying the NEP. According to Sultan (1982, 498-99), these included:

1 concern over the security of global oil supply following the Iranian revolution;

2 desire to insulate Canada from future oil shocks;

3 concern that the province of Alberta would reap excessive rents;

4 concern that foreign companies would siphon off rents;

5 desire of the Canadian Government to pursue an interventionist policy ostensibly to enhance national welfare; and

6 reduce growing federal deficits by capturing a large share of rents from the exploitation of oil and gas resources.

The Canadianization objectives were designed to achieve Canadian ownership equal to 50 per cent of production by 1990, Canadian control of a significant number of larger firms, and an increase in the share of the industry owned by the Canadian Government. The main features and consequences of the original NEP and subsequent agreements and update in 1981/2 are discussed in Helliwell and McRae (1981, 1982) and Scarfe (1983). I shall concentrate here accordingly on those aspects of the NEP which most directly affect Canada/U.S. trade and investment relations and have provoked official U.S. criticism. As noted by Wonder (1982, 483-4), these include:

- a retroactive 25 per cent Crown share, or 'back-in', in existing oil and gas discoveries on Canada (federal) Lands;

- replacement of depletion allowances with a Petroleum Incentives Program (PIP), which establishes a system of incentive payments for exploration and development on a scale reflecting the degree of Canadian ownership and control;

– a 'Buy Canada' policy for goods and services used in exploration, development, and production on Canada Lands and in major nonconventional oil projects.

The retroactive application of the back-in provision is viewed as highly inequitable since it amounts to a rewriting of the investment rules after the fact and may not provide adequate compensation for the expenditures incurred and risks assumed by foreign firms engaged in exploration. The objection to the PIP is that it violates the principle of national treatment by making the incentive payments conditional on the degree of Canadian nationality and control of firms. Finally, the 'Buy Canada' policy is in conflict with Canada's obligations under GATT. This latter policy was modified subsequently, but there is still some question in the U.S. that foreign firms might nonetheless be subject to pressure to source within Canada.

Aside from these particular aspects of the NEP, the U.S. was concerned about Canada's campaign to achieve its goal of 50 per cent ownership by 1990. This involved a number of takeover activities, and some of the U.S. firms affected argued that the NEP had depressed the value of their holdings. The response in the U.S. Congress was highly critical of these and other Canadian takeover activities, and bills were introduced in both the House and Senate in 1981 which were designed to increase the margin requirements for foreign takeovers and to place a moratorium on takeover actions by Canadian firms. These bills languished in Congress, however, once some of the more newsworthy takeover attempts failed to materialize and market reactions to the NEP set in.

Some of these reactions to the NEP were mentioned above. There was a substantial fall in exploration and production expenditures in 1981 and a significant moving of drilling rigs and skilled personnel out of Canada to the U.S. especially. Further, financing of the takeovers apparently resulted in a sizeable depreciation of the Canadian dollar. Citing a Bank of Montreal (1981) study, Scarfe (1983, 44-6) noted that the exchange rate may have depreciated by 1.5 U.S. cents between October 1980 and June 1981 due to the takeover activity. Moreover, since foreign currency loans were used to a large extent to finance takeovers, there would be added interest costs and resulting additional downward pressure on the exchange rate ranging between 1.25 and 5 U.S. cents, depending upon the assumptions made about the duration and rate of the takeover activities.

Since the advent of the NEP, there has been a marked weakening of energy prices which has necessitated some important changes in the pricing, federal-provincial revenue distribution, and taxation of the energy sector in Canada. These changes have resulted in higher domestic prices to Canadian consumers and lower revenues for both the federal and provincial governments. Because of the complexity of the incentive and taxation systems, it is somewhat difficult to determine what has happened to rates of return to producers. But according to Scarfe (1983), the fiscal changes in the NEP may affect existing production adversely and provide somewhat greater incentives for new, higher cost sources of supply. From the standpoint of Canada/U.S. relations, the question remains whether any changes will be made in those provisions of the NEP which the U.S. has identified as being most objectionable. These concern chiefly the 'back-in' provision and the PIP. The U.S. will certainly continue to make known its displeasure with these aspects of the NEP, and it is conceivable that some changes may be made following the forthcoming election in Canada.

Sectoral issues

In addition to FIRA and the NEP, there are a number of particular sectors in which frictions have arisen between the U.S. and Canada. These have involved trade in agricultural products, complaints about subsidies and protectionist actions of various kinds affecting trade in manufactures, and issues connected with production and trade in public goods. Problems have also arisen because of responses to differential deregulation in particular sectors in the two countries. Finally, there are some issues involving extraterritoriality and conflicts of jurisdiction.

Trade in agricultural products

Agriculture has long been subject to domestic intervention in the U.S., Canada, and most other countries. Conflicts are bound to arise when domestic producing interests experience some actual or perceived disruption from imports, or when exporting countries pursue different policies which may disrupt market shares.

In terms of bilateral trade in agricultural products, the U.S. has been concerned about Canada's 'fast track' safeguard system which permits imposition of a variable import levy when Canadian producers may be affected adversely by relatively low domestic prices. It is the U.S. view that this system may be in violation of GATT Article 19, which permits safeguard actions only involving changes in the volume of imports. The system was first used by Canada in October 1982 in response to claims from western Canadian onion growers that imports from the U.S. were having a detrimental impact. The issue here is the extent to which the low domestic prices are a consequence of changes in domestic output and demand or imports. It may be difficult to sort out these various considerations, but sudden upsurges in imports and changes in market shares should be fairly easy to identify. In addition, the U.S. has expressed concern about the tightening of Canadian quotas on imports of eggs and possible subsidies on Canadian exports of eggs to the U.S.

In 1982, the Maine Potato Council instigated an investigation by the U.S. International Trade Commission (ITC) under Section 332 of the Trade Act to determine if the domestic industry was being injured by imports from Canada. The ITC found some evidence of injury, but cited other contributing factors, in particular poor quality control, a shift in consumer preferences from white Maine potatoes to russet potatoes grown in the northwest, and an overall reduction in U.S. potato consumption. The Maine producing interests then filed an antidumping petition against Canadian imports, and the ITC subsequently ruled preliminarily that there was material injury. The U.S. Commerce Department later found preliminary evidence of dumping by Canadian producers. In the final stage of the investigation, the ITC concluded in December 1983 that there was no evidence of material injury and the case was terminated. This particular action is indicative both of the importance of regional agricultural interests, and the way in which these interests may seek to exploit the system of contingent protection that is now central to the administration of U.S. trade policy. It is also important to note that even though cases may be initiated, they may well end up being dismissed.

An example of an action precipitated by the U.S. support program for sugar concerns blended sugars imported from Canada. These are products made in Canada using sugar imported at relatively low world prices and then exported to the U.S. without restriction. To the extent that these blended sugars compete with U.S. domestic sugar and with imports under quota, the U.S. support program may be undermined. The U.S. sugar program falls under a more general exemption for U.S. agricultural programs permitted by GATT in 1950. Given the continuance of this exemption and notwithstanding the criticisms that can be made of it on efficiency grounds, it is not likely that unrestricted imports of blended sugars from Canada will be permitted to continue.

On the export side, problems have arisen as a consequence of U.S. actions intended to deter the EEC from subsidizing its grain exports to world markets. In particular, the U.S. has used 'blended credit' subsidies in selling wheat to some Middle Eastern countries which have traditionally purchased supplies from the EEC. The U.S. action may have a detrimental effect on Canada, however, to the extent that Canadian exports to these markets may be displaced. Canada has an interest in forcing the EEC to limit its agricultural export subsidies and, at times, Canadian wheat exports have been marketed at concessional prices by the Wheat Board. Thus, while there is some potential for bilateral conflict here, the U.S. and Canada are dominant forces in world grain markets and they have more to gain from collaborative efforts than from direct competition with one another.

Subsidies and protectionist actions affecting trade in manufactures

The serious recession occurring in the U.S. and Canada has exacerbated protectionist pressures in various sectors, and some potentially costly actions have been threatened or taken in the U.S. especially. Perhaps the most serious of these involved charges that Canadian softwood lumber exports to the U.S. were being unfairly subsidized because of the comparatively low stumpage prices being paid to the government of British Columbia by private producers for cutting timber on public lands. A countervailing duty action was instigated by U.S. producers and preliminary investigation by the ITC ruled in November 1982 that there might be injury. The Commerce Department then sought to determine the extent of subsidy as the basis for a possible countervailing duty action. It was concluded in March 1983 that any subsidies were *de minimis* and the case was terminated.

The Canadian lumber case is interesting and important for a number of reasons. U.S. lumber producers in the Pacific Northwest had been seriously affected by the weak housing market in the U.S. Imports from Canada may well have made their situation worse, but the chief reasons for their problems were clearly domestic in origin, including being locked into stumpage contracts negotiated in earlier periods when lumber prices were relatively higher. Nonetheless, the U.S. producers instituted a potentially very costly action under U.S. law, given that there was close to $2 billion of trade involved. This is not to say that there is no case to be made against Canadian lumber policy, particularly with respect to bidding practices and the longstanding restrictions on the exports of logs from British Columbia. But these are policies that have been in place for a considerable period of time, and there is no clear legislative authority for challenging them.

Another interesting case involved a countervailing duty action brought in 1982 by the Budd Company of Michigan. At issue was a financing agreement between the Export Development Corporation of Canada and the Metropolitan Transportation Authority (MTA) of New York City, whereby subway cars were to be provided by Bombardier, Inc. of Montreal at a subsidized interest rate. Export-credit subsidies have been a bone of contention between the U.S. and other industrial countries for some time, and it has proven difficult to obtain an international consensus to bring these subsidies under control. In this particular case, the Canadian manufacturer was responding to competitive pressures from other foreign (French) bidders. Yet the action was potentially countervailable under U.S. law. The case in question was never brought to conclusion, however, since the Budd Company withdrew its complaint. The reason may have been that it did not wish to disclose its financial condition in the course of an investigation to determine if there was injury. This is then a further example of the way in which the U.S. system of contingent protection can be used as a technique for harassment of foreign producers, although there were broader issues of export credits present as well.

The Maine potato, softwood lumber, and subway car actions and investigations instituted under U.S. law are vivid illustrations of the workings of the system of contingent protection and the resulting harassment that foreign producers may experience. Yet in these instances the proceedings were terminated. This suggests that the system of contingent protection does not always or necessarily result in actual protectionist measures being introduced by the U.S. Perhaps Canada has simply been fortunate thus far in this regard. But it might just as well be argued that the administrative procedures followed under U.S. law may serve to defuse protectionism rather than reinforce it.

Before concluding this section, it is worth noting some other actions taken which have important bilateral implications. For example, the 'Buy America' provision was amended in the U.S. Surface Transportation Act of 1982. This amendment, which was not covered under the GATT procurement code, increased the preference from 10 to 25 per cent for cement and structural steel for transportation projects financed with federal funds. Canada has requested a waiver of the provision for projects in border areas. Vehicles were covered in the amendment originally, but a waiver was obtained to exempt Canada. The issue of a further waiver presumably can be resolved through bilateral discussions if the U.S. is agreeable.

Finally, as mentioned above, Canada's exports of selected steel products to the U.S. may have been adversely affected by relief granted to U.S. producers under the Trade Act. In this case, countries other than Canada represented the source of the alleged difficulties, but the policy of restraint made no distinction among supplying countries.

Actions of concern to the U.S. include passage of legislation to extend Canadian customs jurisdiction to 200 miles or to the end of the continental shelf and the compulsory licensing of pharmaceutical patents. The extension of the customs jurisdiction will involve levying tariffs on oil-drilling ships and equipment beyond the 12-mile limit, which is apparently without precedent. The compulsory licensing of pharmaceutical patents has affected U.S. firms adversely because of the short period of patent protection realized in Canada and the relatively small royalty provided thereafter. This policy is actively under review following complaints by some major drug companies in Canada and accompanying reductions of their Canadian operations.

Issues involving public goods

There are some vexing environmental issues, acid rain in particular, and questions concerning fishing rights and water quality and use that are under active discussion between the U.S. and Canada. I shall not attempt to deal with these matters, however, but instead will discuss some issues involving transborder telecommunications and national defense.

The U.S. and Canada have common interests in the development and use of satellites for the transborder communication of data, hemispheric broadcasting, and other telecommunication services. There are important and sensitive issues of national policy at stake here, and the relevant agencies in each country are in close contact in exchanging views and seeking areas of bilateral agreement. Two areas of current bilateral concern involve border broadcasting and copyright retransmission.

Since 1976, Canada has denied Canadian firms tax deductions for the cost of foreign advertising which is directed mainly at Canadians. This had a clearly adverse impact on U.S. television stations whose programming could be received in Canada. A Section 301 petition was filed in 1978 by 15 U.S. border broadcasting stations, and in 1980 a determination was made that the Canadian action was injurious to U.S. commercial interests. It was proposed then and again in 1981 that the U.S. Congress enact comparable legislation aimed at Canada, but no action was taken. In the summer of 1983, legislation was once again introduced in the Senate. The issue is now under study in Canada in connection with an official review of the Canadian Income Tax Act, but it is not clear how it may be resolved.

With respect to copyright retransmission, the U.S. has objected to the existing Canadian cable law and broadcast policy which denies U.S. copyright owners compensation for retransmission in Canada of material broadcast by U.S. border stations. The U.S. has compulsory licensing covering copyright retransmission, and there is some sentiment in Congress for prohibiting payments to Canadian copyright owners pending a change in Canadian policy. This issue is at the moment unresolved.

An issue involving national defense concerns the U.S. restrictions introduced in 1982 on the importation of specialty metals in Department of Defense procurement. These metals include titanium, zirconium, nickel, iron-nickel, and cobalt base alloys. Canada sought a waiver which would permit the export of bulk specialty metals on the grounds that they are distinct from defense systems. The argument was that it made sense to view a single North American industrial base for purposes of mobilization and defense, and that the amount of defense procurement was only about 5 per cent of total U.S. production. The Department of Defense supported the request for a waiver, and legislation has been obtained to grant it.

Canada/U.S. relations involving public goods clearly entail many sensitive areas of national concern. Nonetheless, when costly restrictions are introduced that are inimical to economic welfare, it would be desirable to seek accommodations in policies that will mitigate detrimental cross-national impacts and promote joint objectives.

Issues of deregulation

In recent years, there has been a significant movement towards deregulation in a number of important sectors in the U.S., including surface transportation, airlines, banking and financial services, energy and telecommunications. Deregulation is also occurring in Canada, but probably to a lesser extent than in the U.S. Because of national differences in regulations affecting particular sectors, some problems have therefore arisen between the U.S. and Canada.

With the deregulation of trucking in the U.S. under the Motor Carrier Act of 1980, Canadian trucking firms have been able to operate in a liberalized environment along with U.S. firms. In Canada, a U.S. trucking firm must obtain provincial approval as well as approval from FIRA. U.S. firms have alleged that the Canadian regulatory systems place them at a competitive disadvantage vis-à-vis Canadian firms. There was also a dispute that arose over air fares when the U.S. denied permission for a Canadian airline to offer discounted fares for certain flights from Canada to the U.S. This was in retaliation for earlier Canadian action which prevented a U.S. carrier from matching a Canadian competitor's fares within Canada.

The complaints of U.S. trucking firms involve the issue of national treatment mentioned earlier, although there is an element of reciprocity present in both this instance as well as in the airline-fare disputes. As differential deregulation occurs in other sectors, it is likely that further bilateral frictions will arise. The procedures and resolutions of the bilateral disputes in the transportation sector may well be suggestive in handling potential problems elsewhere that may occur in the future.

Extraterritoriality and conflicts of jurisdiction

There have been several occasions in the past when U.S. policy actions affected foreign subsidiaries in Canada and elsewhere and thus led to conflicts as to whether the U.S. had appropriate jurisdiction. The U.S. actions have involved extraterritorial application of such laws as antitrust, trading with the enemy, control of foreign assets, and export controls and sanctions. In addition, several U.S. regulatory agencies have the authority to act with extraterritorial jurisdiction.

Thomas (1983) argues that the U.S. claim to the legality of extraterritorial application of U.S. antitrust law and presumably other U.S. laws and regulations has no basis either in international law or international relations. Under these circumstances, it is not surprising that unilateral U.S. extraterritorial actions may provoke diplomatic conflict. Canada is particularly vulnerable to the extraterritorial application of U.S. laws and regulations in view of the extensive amount of its trade and direct foreign investment involving the U.S. This is not to say that Canada's interests will necessarily be adversely affected in every case, for there may be circumstances in which it could gain, as for example, by elimination of anticompetitive behavior in response to U.S. antitrust proceedings. Nonetheless, there is wide scope for U.S. legal intervention in Canadian affairs which could prompt Canada to institute retaliatory legislation or actions if the views and interests of the two countries happen not to coincide.[5]

POLICY OPTIONS FOR RESPONDING TO CANADA/U.S. TRADE AND INVESTMENT FRICTIONS

Having reviewed the major sources of friction between the U.S. and Canada relating to trade and investment, it may be useful to consider the policy options available for responding to these frictions. A useful classification of the various options has been provided by Hufbauer (1981), as follows: inaction; bilateral efforts; multilateral efforts; and unilateral measures, including public response, mixed public-private response, and private actions.

A policy of inaction is premised on the assumption that if intervention is damaging to a country's interest, there will be market responses which will bring about pressure for change. In other words, market forces will punish the interventionists. The market reactions to the FIR Act and the NEP noted previously are perhaps instructive here. The difficulty is, however, that the negative impacts of the intervention are not avoided to begin with, and, given the nature of and time lags involved in the political process, the damaging effects may persist for some time. Bilateral efforts may be important and useful therefore to head off frictions and seek to reduce or remove them once they occur.

The U.S. and Canada have a long tradition of official contacts at different levels of government, and in general this process has worked smoothly and effectively. Relations have nonetheless been strained by national policy actions on occasions when there may have been little prior communication between the countries or when existing channels have malfunctioned. Again, FIRA and the NEP are cases in point, as Wonder (1982) has noted in discussing the interagency problems reflected in the Reagan Administration's initial dealings with Canada over these issues and the Congressional pressures for retaliatory actions. Once unfavourable market reactions began to occur, however, especially during a time of recession, pressure on Canadian authorities mounted from the private sector and the provincial governments to effect significant moderation of the policies. Some credit for these changes should also be attributed to the eventual clarification of U.S. official views and the pursuit of U.S. interests in bilateral dialogue. In any event, the bilateral relationship is currently (September 1983) functioning much more smoothly than was the case a year or two ago.

In order to help resolve future bilateral disputes, the idea of establishing a Canada/U.S. Commission on Trade and Investment might be worth exploring along the lines suggested in Macdonald (1982). As he notes in reflecting on previous experience in managing bilateral relations:

> when an institution has been established between the two governments to deal with matters of high policy, such as ministerial committees to resolve economic problems, it has not worked. Ministers are in politics and refuse to be confined to the Procrustean bed of a single institution. They need more manœuverability than a bilateral committee can provide.
>
> Conversely, where an issue involves an immense amount of detail, humble detail, and calls for a high order of expertise

> and where it entails no major political question, bilateral institutions have been successful. (231)

A commission of this kind would function mainly in a factfinding role and as a means of promoting conciliation of trade and investment disputes. It would not replace existing multilateral arrangements, although it could be extended to include relations with other important countries or regions such as Japan and the EEC. As noted, a commission would not necessarily be effective when there were important political stakes involved in bilateral disputes, as for example in the cases of FIRA and the NEP. Intergovernmental diplomacy and the resort to multilateral dispute settlement procedures would then be in order.

Turning now to multilateral policy options, they are best designed to complement and reinforce bilateral efforts. Thus, for example, it may be fruitful to pursue multilateral discussions and negotiations to clarify and limit the use of investment-performance requirements. The difficulty is, however, that multilateral efforts may take a long time before agreement can be reached, and even then the agreement may not be effective unless countries are motivated to limit the extent of their interventionist policies. It is nonetheless important for the world economy that there be an effective multilateral framework governing international trade and investment. The U.S. complaint in GATT concerning Canadian local-content and export-performance requirements is an important example of bringing multilateral authority to bear on an issue that is troublesome bilaterally but has implications that go beyond the particular case. This point also applies to other policies that come under the purview of GATT, especially subsidies and countervailing duties, antidumping actions, and government-procurement restrictions. Thus, bilateral and multilateral policy initiatives and responses should proceed in tandem.

A case for unilateral measures can be made when bilateral efforts do not succeed and multilateral efforts are too time consuming or not clearly applicable. As Hufbauer (1981, 8) notes: 'The art is to design [unilateral] measures that do not overreact, that redress the injury caused, that penalize the offender, and that minimize harm to innocent parties.' Clearly this is no easy matter. Unilateral measures include what Hufbauer has called public response, mixed public-private response, and private right of action.

From the U.S. standpoint, public responses include resort to Section 301 of the Trade Act which relates to foreign actions which are damaging to U.S. commercial interests. This was used in the border-broadcasting dispute engendered by Canada's disallowing tax deductions for advertising in foreign media aimed at Canadian consumers. The U.S. proposed 'mirror' legislation in the Congress, but no definitive steps were taken apparently because of objections by U.S. media interests. Other public responses include the threat to amend or abrogate existing bilateral treaties relating to investment or taxation or to place restrictions on the availability and terms of foreign credits. The main drawbacks of these various measures of public response, as Hufbauer (1981, 10) has noted, is that they may become dominated by political considerations and not really address the injury of the parties involved.

A mixed public-private response is when a complaint is initiated to a public agency by the parties (e.g., firms, workers) directly affected by a foreign action. The agency will then institute an investigation to determine if injury has occurred and, if so, it will recommend an appropriate response. This is of course what exists already in the system of contingent protection that is in place in the U.S. and elsewhere. A mixed public-private response has merit insofar as it can address directly the interests of the parties involved and be used to place leverage on the other country to change its policy. There may be serious drawbacks, however, since it is difficult to devise and implement a mechanism of response that is capable of distinguishing legitimate cases of injury from simply protectionist demands. Also, political factors may be introduced.

Finally, the private right of action is when the party affected can institute judicial proceedings under the appropriate statutes and seek redress from the offending party. This would require clear statutory authorization to cover the various circumstances in which injury may be claimed to have occurred. It would also be necessary to coordinate and harmonize these private rights of action with existing bilateral and multilateral obligations and mechanisms for resolving disputes.

If we consider the range of policy options, the combination of inaction, bilateral efforts, and multilateral efforts seems preferable to the various types of unilateral measures noted. The reasons are that unilateral measures may become highly politicized or be transformed into mechanisms of protection.

CONCLUSION

Given the proximity of the U.S. and Canada and the substantial interdependence which characterizes their trade and investment relations, bilateral frictions are bound to arise. Following the introduction of the NEP in 1980 and the tightening of the FIRA review process, Canada/U.S. relations were subject to considerable strain. Bilateral relations have become more harmonious, however, as Canadian policies were moderated. From the U.S. standpoint, the NEP and FIRA nonetheless continue to pose difficulties because they violate the principle of national treatment and may involve the imposition of potentially damaging performance requirements. Canada's chief worry will continue to be the impact of U.S. trade actions that are mandated by the system of contingent protection.

There are several policy options available for dealing with bilateral issues. My preference is for a mixture involving inaction, bilateral consultations, and efforts to extend and improve bilateral and multilateral procedures and mechanisms for resolving conflict. The U.S. has a variety of unilateral measures that might also be used. But since these measures may become politicized or transformed along more protectionist lines, I find them less promising.

NOTES

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2 I might mention here the views of proponents of Canada/U.S. free trade, such as Wonnacott and Wonnacott (1982), who assert that existing tariffs in *both* Canada and the U.S. are especially detrimental to Canada. It is argued that the U.S. tariff prevents Canadian manufacturing firms from exploiting economies of scale which might otherwise be realized if their markets could be enlarged. In

addition, the U.S. tariff is alleged to impede investment and reorganization by Canadian firms to serve the U.S. market. If free trade were permitted between the two countries, Canada would presumably realize significant benefits. A further benefit might be a reduction in bilateral frictions since Canada would have a greater voice in affecting U.S. trade and investment actions. Not everyone shares this enthusiasm for free bilateral trade, however, since there may be an exaggeration of the gains from higher productivity and of the barriers that supposedly impede the expansion of Canadian manufacturing firms. See, for example, Wilkinson (1982).

3 For details, see especially FIRA (1982).

4 For some useful references concerning FIRA and related issues involving the regulation of foreign direct investment and performance requirements, see Bale (1982a, b; 1983); Dewhirst (1982); Fontheim and Gadbaw (1982); Gotlieb (1982b, c); Hufbauer (1981); Hufbauer and Samet (1982); McCarthy (1982); Safarian (1982); Stocks (1982); U.S. ITC (1982, esp. 120-42; 1983, esp. 144-5); and Wonnacott (1982a, b).

5 In this connection, see Thomas (1983, esp. 29-30) and Gotlieb (1982a, esp. 18-19).

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Comments

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I found the paper by Professor Stern to be a timely, readable, and useful summary of the trade and investment frictions between Canada and the United States over the 1980-3 period. It highlights quite naturally the NEP, FIRA, and a number of the sector-specific issues which have arisen. The main topic I wish to dwell on at some length is the issue of contingent protection and how it affects a small open economy.

Before turning to those issues however, I will add a couple of points about the effect of the size asymmetry on the economic relations between the two countries. Professor Stern's papers covers a number of the important issues in this regard. Nevertheless, from the Canadian perspective, his paper does not convey the intensity of feelings which typically are expressed in the discussion of the impact of the United States on the Canadian economy. There is a long history in Canada of nationalistic rhetoric, or argument, depending upon one's views, as to the harmful effect that the significant degree of foreign ownership of Canadian industry has on economic performance and political independence. As these views are held by a vocal and politically active group in Canada, they inevitably carry weight in economic policy discussion. The paper also contains little discussion of the effect that the ongoing battle between the provinces and the federal government of Canada has on the conduct of trade policy. These two 'facts' are at the heart of Canadian political economy, and each played an important role in the early 1980s. It is also fair to say they will continue to play a role in the design and conduct of Canadian trade and investment policy; how important they will be over the rest of the decade is difficult to predict.

Contingent protection

The general use of contingent protection devices by countries throughout the industrialized world in the 1980s has been interpreted by some observers to signal the end of the generally harmonious trade relationships conducted under the auspices of GATT and the beginning of a new and dangerous protectionist stance by many countries. Professor Stern's paper summarizes the Canadian concern over the United States' use of countervailing duty legislation. The well publicized cases of potential countervail against B.C. lumber imports to the U.S. and the Bombardier sale of subway cars to New York gave many Canadian businessmen a new perspective on exporting to the U.S. market. While contingent protection devices such as countervail and antidumping legislation were intended as trade liberalization devices, it is conceivable they may well turn into strong protectionist measures. Definitions of what constitutes 'unfair competition' and 'subsidy' inevitably lead to arguments incapable of resolution given the participants in the argument hold their views in an entrenched manner. The grey area which surrounds the rules and customs of contingent protection gives considerable scope for creative interpretation of contingency legislation, and for initiative on the part of involved interest groups in implementing the procedures designed to trigger the occurrence of a 'contingency'. The problem is that triggering the procedural mechanisms of contingency protection is a matter of *bureaucratic*, private sector, and political initiative. Given that bureaucracies are 'captured' to a considerable degree, the expectation is that contingencies will be found to be rather prevalent. This is not a new argument. It is yet another case of the 'rules versus discretion' debate which goes on throughout the discussion of economic policy.

If contingency protection becomes a substitute for tariff protection, what is the long run impact on a small open economy such as Canada? Contingency protection by its very nature means that anyone contemplating exporting faces an investment decision under uncertainty with the associated risks and rewards. The central Canadian interest in freer trade between Canada and the United States is that Canadian producers should get access to the large U.S. market allowing them to reap economies of scale in production, distribution, and marketing.

Contingency protection may seriously undermine the ability of Canadian firms to do so.

Let me try to make the point in analytical terms. It is now commonplace to speak of the conditions of competition as determined by whether a market is *contestable* or not. In simple terms a market which is contestable is one in which over a relatively short period there is freedom of entry and *exit*. Contestable markets are said to be subject to 'hit and run' entry. At the other extreme, a noncontestable market is one where entering the market involves a relatively long lived and irreversible investment – capital committed is industry or activity specific. In the context of international competition across national boundaries it is useful to think of a firm competing from a foreign base as entering the import-competing market, and to distinguish this from the market in which the domestic firms within the same industry compete. The difference between the two groups of firms comes from the differences in the nature of the investment decisions involved in selling by the two groups. In particular, it is possible that foreign firms will require a greater level of investment than that required by domestic firms to achieve the same market share, or the opposite may occur. The central distinguishing feature of the foreign market from the viewpoint of exporters that I wish to emphasize is its degree of contestability. If it is contestable a foreign firm can conduct hit and run entry when profitable opportunities exist. If it is not contestable, then getting into the foreign market requires substantial investment and, subsequent to entry, should firms find they would like to get out, it would be quite costly to do so.

It is clear that contingent protection will have quite different effects on foreign entrants depending upon whether the market as viewed by these entrants is contestable or not. If the market is contestable contingent protection should have little or no long run effect. If the market is not contestable the expectation by foreign firms of some average level of contingent protection reduces the expected return and increases the risk to entering that market. The supply of exporters will accordingly be withdrawn and import substitution will occur. To reiterate, it is the contestability of the foreign market which fundamentally determines the long run effect of contingent protection.

What of the small versus large economy, and in particular of Canada versus the United States? I wish to make two points here.

First, that for Canadian firms entering the U.S. markets, the act of entry involves entering a noncontestable market and therefore contingent U.S. protection will have a significant long run effect on Canadian exports. Second, that for U.S. multinationals the Canadian market is relatively more contestable than their home market, and therefore contingent protection by Canada will have relatively less effect on the long run exports to Canada by U.S. firms than similar levels of protection in larger markets such as the EEC. Both of these propositions follow from the size asymmetries of the two countries and their respective shares of the world market. Serving the U.S. market will inevitably involve substantial investment in marketing and distribution networks. Typically these costs will be nonrecoverable should profitable entry fail, and in many cases the foreign competition will have already sunk these costs putting the Canadian entrant at a strategic disadvantage. This will not universally be the case, though; if the Canadian firm has a completely new product providing a new service, or an existing service at lower cost, then the entry barriers may be low and the exit barriers surmountable. For the Canadian entrant the costs of entering the U.S. market will usually account for a large fraction of its total costs, and the U.S. market will account for about 80 per cent of the firm's total market. In the presence of contingent protection the firm puts a substantial amount of its total resources at stake. It is difficult to imagine how implicit or explicit insurance markets could diversify this risk.

Contingent protection by Canada on the other hand would have little effect on U.S. or other large multinationals entering the Canadian market. First, the Canadian market is contestable as viewed by many of these firms in many of these industries. Horizontally and vertically diversified MNEs put little total capital at stake in any single foreign product market because of the public good aspect such investment has with respect to all product lines of the firm in the foreign market. Furthermore investment in the form of brand image in a small country is often not required. This is particularly true in Canada where consumers are regular recipients of U.S. advertising messages. This mitigates to a significant degree entry costs of a large U.S. firm. Secondly, because the total Canadian market is such a small share of the total world market, or even the North American market, the U.S. firm entering the Canadian market would be risking at most 20 per cent of total sales. In a diversified marketing portfolio the risk component attached to the Canadian market would be small. It is clear then that contingent protection by Canada against foreign firms, while it would have the obvious short run effects, would be an ineffective device for inducing long run import substitution. Related is the observation is that a great deal of Canadian imports is part of intra-firm trade by MNEs; it would be very difficult to design contingent protection mechanisms which would work effectively against these imports.

The implications of this analysis are twofold. First, in entering discussions with the U.S. about free trade on either a comprehensive or more limited 'sectoral' basis, Canada should seek to get assurances that contingent protection by the U.S. will not become the rule rather than the exception. This strikes me as the most difficult aspect of negotiating a Canada/U.S. free trade pact in present circumstances for a number of reasons discussed elsewhere in this volume.

The other point, is that either with or without a Canada/U.S. free trade pact, if contingent protection becomes prevalent, Canada stands to lose a great deal in its export markets. Furthermore, for the small country to achieve the same degree of reciprocal protection as in the larger country would require more extensive, or intensive, use of the contingent protection devices than in the larger countries. The danger, in these circumstances, of retaliatory response by the larger country would be great. Contingent protection is clearly an ineffective instrument for a small country. Analogies of contingent protection to conventional tariff protection are not appropriate. Hopefully, both forms of protection between Canada and the United States can be reduced and avoided.

Comments

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As Bob Stern has stressed, the purpose of his paper was to review the major frictions between Canada and the U.S. and to *review* the range of policy options available to reduce or remove these frictions. Unfortunately, since the paper doesn't really come to grips with *why* these frictions have come to the fore, it falls short in its treatment of the policy options.

The paper, very usefully, lays out some of the key facts in the relationship. There can be no doubt that the asymmetric nature of the relationship – both in terms of trade and investment – colours the perception of the importance of any given issue and, for that matter, their total significance on either side of the border. The asymmetry is graphically illustrated by the fact that the bulk of Canadian trade and foreign investment takes place with or has been sourced from the U.S., whereas the bulk of total U.S. trade and investment takes place with other countries and regions of the world. Yet the fact remains that no *single* country in the world is as important to the U.S. as a market or as a place to invest as is Canada.

Despite this, Ambassador Mansfield was recently quoted as stating that as far as the U.S. was concerned, 'the U.S.- Japan partnership is the most important bilateral relationship bar none.' In addition, President Reagan, prior to his most recent trip to Japan, said Japan was the U.S.'s most important trading partner.

This raises the question whether such statements are bred of ignorance or of complacency about the Canadian relationship.

It was to be hoped that the paper would offer some fuller insights into why the U.S. has taken the posture it has in recent years not only on specific issues with Canada but also with respect to the totality of the relationship. Presumably attitudes to government intervention are symptoms of broader differences on either side of the border. Such insights are important to an understanding of how frictions can be dealt with or even how the broad relationship can be managed to avoid or reduce future tensions.

Instead, the paper presents two shopping lists. A dozen areas of friction are cited from the U.S. perspective and half a dozen from the Canadian perspective. The paper simply outlines the tensions without exploring in more depth their causes. Surely it shouldn't surprise us that there are very real and very important tensions between Canada and the U.S. These will always exist between two sovereign nations. What is interesting is why they get out of hand. One would assume that because of the magnitude of the flows involved between the two countries both sides would have a vested interest in keeping such tensions manageable. There are after all hundreds of thousands of jobs at stake on both sides of the border.

Some understanding of the causes – not simply the effects – would prove invaluable for policymakers and politicians in managing this relationship. It would have been useful if the paper had attempted to link given frictions or groupings of frictions to a range of potential causes, thereby enhancing our knowledge and understanding.

The following questions might usefully be pursued in identifying some of these casual factors:

– How far are the frictions linked to the ability of narrow private sector interests to manipulate Congress?

– How far are they linked to the clash of political personalities on either side of the border?

– How far are they the spillover of inherently U.S. domestic issues?

– How far a manifestation of an attitude that U.S. capital and technology developed a resource than 'belongs' to Americans, no matter where the resources are located?

– How far are they related to very fundamental conflicts of national interests – conflicts that are exacerbated in hard economic times?

– How far do they reflect that inherent reticence (borne of distrust) by Congress in leaving sufficient discretion to the Administration to make pragmatic compromises with U.S. trading partners?

– How far are they linked to an American failure to understand that, despite a shared language, Canadians have by and large not been inspired by the romanticism of Rousseau to be unshackled but rather have felt more comfortable with the Hobbsian view that mankind needs the discipline and the benign hand of government?

– How far do they reflect the frustrations of a dominant but vulnerable world economic power concerned with maintaining that leadership while developing the conviction that the game isn't being played on a level playing field?

This list is not exhaustive. But it is offered as a basis for future work and insight. If we have some of the answers presumably we would have some insights into how the relationship can be better managed.

Against this kind of set of causal factors it is not clear that frictions can be addressed only through either bilateral/multilateral efforts or through benign neglect. Perhaps there is scope for some healthy navel-gazing on both sides of the border – at least the need to question whether in an increasingly interdependent world it is posible to pursue purely domestic policies and maintain parochial attitudes without shooting oneself in the foot.

Canada/U.S. economic relations: a Canadian view

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INTRODUCTION

Canadians and Americans have quite different perceptions of their economic ties – in particular, the trade flow between the two countries which is greater than any other trade flow that has ever existed. While this trading relationship is clearly important for Americans, it is not a cause for constant preoccupation: the U.S. still has a relatively balanced set of economic interests, based on substantial trade flows with a wide variety of other countries – in particular, with Japan, and the major countries of Europe. On the other hand, for Canadians, this Canada/U.S. trading relationship is of much greater concern, for two reasons:

– It represents an overwhelming proportion of our total trade: our trade with the U.S. alone is more than *double* our trade with Japan, Germany, the UK and *all other countries taken together*.
– It's not just that the U.S. plays a dominant role in our trade. In addition, trade plays a much greater role in Canadian economic activity: exports generate a much larger proportion of GNP in Canada than in the U.S.

These two considerations can best be summarized by noting that although Canada is the U.S.'s biggest export market, such U.S. exports to Canada in 1982 generated only about one per cent of U.S. GNP; however, Canadian exports to the U.S. generated roughly 16 per cent of Canadian GNP.

This means that if the two countries introduce restrictive policies against the other's exports which are nominally equivalent, the relative damage done to the Canadian economy will greatly exceed that to the U.S. To extend this argument further, consider countervail. The risk that U.S. countervail may be invoked in the future may effectively prevent a company wishing to service the North American market from establishing in Canada – because, by so doing, it would run the risk of a future U.S. countervail that would damage its sales in more than 90 per cent of the North American market. (Here we use North America loosely, to represent only Canada and the U.S.) Accordingly, the firm establishes in the U.S., where the threat of *exactly the same* Canadian countervail would involve little risk: less than 10 per cent of its market would be affected.

(This is not necessarily an argument against countervail as an economic instrument, although a strong case can be mounted against it if it is used as a protectionist rather than a free-trade device. Of course, the problem of sorting out which of these is the real motivation is often a near impossible task, so the issue is one on which it is difficult to be categorical. More on this later.)

But before leaving the subject of countervail there are, I believe, some interesting observations to be made, in particular in terms of its 'near-miss' application by the U.S. earlier this year to Canadian exports of lumber. The damage this would have done to Canada is obvious, in terms of the shock to the already depressed British Columbia economy. But there would have been severe damage to the U.S. as well, from the more rapid escalation of domestic lumber prices that would have occurred, with the problems this would have raised for the U.S. in its attempt to wring inflationary expectations out of the system. The progress made so far would have been seriously jeopardized by the more rapidly rising price level in construction – one of the sectors leading the recovery.

The implications for Canada had this U.S. countervail been imposed would also have been interesting. Government-determined stumpage fees, set at a level below the market price, have provided at least some encouragement for Canadian exports. The problem has been that over time this advantage has not remained with the exporting companies, but has instead been absorbed in higher wage contracts in the lumbering industry. But these contracts have tended to lead wages in other B.C. industries; thus wages and costs in B.C. have become elevated in other industries that can't afford it (i.e., where an advantage such as low stumpage fees has not existed). This has been viewed by Canadian economists as an important reason for the combination of relatively high wages and high unemployment rates that have been observed in B.C. But for our discussions here the really interesting observation is this: suppose that advantage to the lumber industry had been captured not only by the labour force in lumbering, but then *also* by the U.S. treasury this year in the form of countervailing duties. Had these duties been imposed, the encouragement to the industry in the form of low stumpage fees would, in the process of being lost *twice* – once to the local labour force, and once to the U.S. treasury – have made B.C. lumber exports *less*, rather than more competitive in the U.S. market.

To return to the main thrust of this paper, the Canadian dependence on the U.S. market, plus the existence of economies of market size in Canadian manufacturing, make it crucial for Canada to ensure that our economic relations with the U.S. are not jeopardized. This is clearly not an absolute guideline for Canadian policy: we must be prepared, for example on policies of clear political principle, to run the risk of U.S. retaliation against our exports, with the costs this would involve for Canada. But it makes no sense whatsoever for Canada to risk jeopardizing our relationship with the U.S. by introducing a policy that offers no advantage to Canada – and it is more questionable yet again to introduce a policy that not only offers no benefits, but involves *costs* to Canada.

An example that comes to mind is the National Energy Policy's 25 per cent back-in on Crown Lands – a policy that, in addition to affecting the atmosphere in which U.S. trade decisions are made, involved other, even more concrete costs to Canadians as well, due to the unfavourable effects on foreign investors' confidence in the Canadian economy, and hence the adverse pressure on the Canadian capital account. These costs may have been subtle and indirect, but they were far from inconsequential: the adverse capital account pressure was offset by Bank of Canada support for the Canadian dollar via domestic monetary policy that raised interest rates to higher levels than they would have otherwise reached. Thus the damage to Canada was a more severe recession and a higher level of unemployment.

The NEP also increased the financial leverage on the Canadian economy at a time when leverage became very costly. The NEP's discriminatory tax policy that made oil assets worth less to foreigners than to Canadians led, as one might have expected, to substantial purchases of these assets by Canadians. The resulting capital outflow was offset by a capital inflow generated by the above-mentioned tight (high interest rate) policy of the Bank of Canada in its attempt to stabilize the Canadian dollar. Thus as a nation we were acquiring oil assets by increasing our foreign debt. Moreover, we were doing it at the worst possible time – when both the value of oil assets and the interest cost of carrying debt were inflated. Thus, the Canadian economy as a whole has become entangled in the same problem of leverage and increased exposure that, in a relatively more serious form, drove Dome to the brink of bankruptcy.

But while it is true that many of our problems have been self-inflicted, there are many over which we have had little control. The level of interest rates in Canada has been very high in the early 1980s not only because of capital account pressures generated by nationalistic policies such as the NEP, but also – and even more important – because interest rates have been high in the U.S. Indeed, these high U.S. rates have raised problems within the U.S. economy that have indirectly yet seriously threatened Canada. Specifically, the 1981/2 combination of extremely high American interest rates and recession, generated protectionist pressure in the U.S. – a pressure that was augmented by two other problems brought on by high interest rates: a slower rate of U.S. capital formation, and a high value of the U.S. dollar. Both of these made it difficult for U.S. industry to export and compete with imports, and hence for the U.S. administration to resist protection – protection which is, of course, particularly damaging to the Canadian economy.

(With the recent economic recovery, these pressures are becoming less severe. The question in the short term thus becomes: 'How substantial and sustained will the recovery be?' The answer to this will in turn be influenced by what happens to U.S. interest rates: 'Will they rise again, as the recovering business demand for funds augments the continued pressure on financial markets by the U.S. treasury? To what degree, if any, will this pressure be offset by downward pressure on interest rates, as the flow of savings increases with recovery, and the expectation of inflation adjusts to the low inflation rate that now prevails?')

I'd like to turn now to what I judge to be a manifestation of U.S. protectionism that is potentially of great concern to Canadians.

THE NEW U.S. RECIPROCITY[1]

While this could raise special problems for Canada (which I consider later) I begin by considering how the U.S. might apply this policy to Japan – the favourite 'designated target'. Proponents of the new reciprocity proposals that have recently come before the U.S. Congress have argued that if the Japanese are protecting their economy in subtle ways, they should be told that there will be a clear and unambiguous U.S. response: equivalent barriers to Japanese goods entering the U.S. market. Thus, the U.S. can make clear to the Japanese that the protectionist policies they have (correctly or incorrectly) viewed as increasing their welfare will turn out to clearly and obviously reduce their welfare because of the damage the U.S. response will do to Japanese exports. In this way, it is hoped, the U.S. may be able to discourage the Japanese protection that damages U.S. exports.

Unfortunately, this policy is not that simple; so I would like to consider it in some detail. First, as it is currently being used in U.S. debate, it represents an entirely new interpretation of the term 'reciprocity'. Whereas this term had been used in the past to describe policies aimed at liberalizing trade, it hasn't been clear whether the form of reciprocity that's been considered in the U.S. in the last few years would liberalize or restrict trade. To clarify this issue, consider four very different ways the term 'reciprocity' can be defined:

1 Active policies to liberalize trade by reciprocally reducing tariff barriers between all countries (multilateral reciprocity) or between two countries (bilateral reciprocity). The expected effect of such policies is increased trade with collective welfare gains (with possible exceptions, such as the case of bilateral reciprocity where there is substantial enough trade diversion to make costs exceed benefits).
2 Passive policies of withholding trade concessions to countries that are not prepared to reciprocate.

3 Policies of matching any increases in foreign protection with automatic increases in U.S. protection. If such policies are imposed, they will increase protection; on the other hand, if they succeed as threats and are then dropped, they will be trade liberalizing (at least in the sense of preventing the present trading system from becoming more protectionist).

4 Policies that would allow the U.S. to impose new trade barriers against countries whose existing barriers to trade are judged by the U.S. to be higher than corresponding American barriers. Such policies would be more likely to be used as a protectionist device. We shall refer to this category of policies as the 'new reciprocity', or in the phrase used by William Cline (1982) 'aggressive reciprocity'.

Note that the further we go down this list the less likely that the policy will be a liberalizing device, and the more likely it will turn out to be protectionist. Historically, Americans have used this term 'reciprocity' in the first (and perhaps the second) sense. Now it is being used in the third and – particularly before Congress in 1982/3 – in the fourth sense. It is this category of policies that we shall now analyse in detail. First we consider, in the light of a 'new trade literature', the claim that such policies legitimately deserve public support.

Can comparative advantage be 'created' or 'engineered'?

Much of the intellectual credibility of this new U.S. policy proposal is based on the view that, in a wide range of emerging products, comparative advantage may be arbitrary – that is, created or engineered rather than determined by traditional considerations, such as factor endowments. Of course, the production of oil and bananas is still determined by endowments; but they are, according to this view, becoming less and less influential in a broad range of high-tech products that may now be almost equally well produced in the U.S., Europe, or Japan. Three possible reasons have been suggested for this:

1 Differences in factor endowments – especially between North America, Europe, and Japan – are no longer as important as they used

to be because some factors have become more freely available. For example, one factor crucial for high-tech industries – namely, capital – has become increasingly mobile between countries. And the more freely capital moves between countries, the less important are differences in labour/capital endowments. Moreover, in many new high-tech products, natural resources are not an important factor.

2 Technology has become a more critical consideration. Indeed, it can be argued that, as an extension of the idea of human capital, technological capacity should be viewed in its own right as a factor of production – and an increasingly important one at that. Since technological capacity is, like capital, 'created rather than endowed', a natural question is: How can it be created, and thus provide a future comparative advantage in technology-intensive industries – which in many (but not all) cases are rapid growth, high income industries?

3 Economies of scale may mean that the first country to develop a product will be the low-cost producer – even though it may not have the lowest attainable cost curve (i.e., even though, roughly speaking, it may not have a comparative advantage). Its 'comparative disadvantage' may be more than offset by the advantage it achieves from the head start which gives it the highest volume and lowest cost. It may then be able to use this 'volume' cost advantage to deter entry by other producers – perhaps even producers with a slightly lower cost curve, but inadequate volume to compete.

In these circumstances, the U.S. concern is that the Japanese may be able to create a comparative advantage in technology-intensive goods through their current policy of 'targeting' certain of these products, and then subsidizing and protecting them in the Japanese market – while at the same time enjoying the relatively free access these goods get into the U.S. market.[2] Suppose this targeting policy of the Japanese succeeds in 'picking a future winner'. (We assume this hereafter, while recognizing that in practice it's not that easy; often the Japanese pick losers instead. But they're not as visible, because winners get across the Pacific, but losers don't.) To the degree that Japanese targeting *is* on winners, the Japanese may judge, strictly from their own narrow point of view (and assuming no retaliation by the U.S.) that this sort of modern-day 'infant protection' may be justified.[3] This justification may follow from the profits that are eventually earned in these activities[4], plus externalities such as the additions these activities make to the Japanese technological endowment that may create a comparative advantage for Japan in future high-tech activities. An example cited has been the Japanese fostering of production in 16K and 64K RAM (random access memory) semiconductor chips.[5]

Suppose a U.S. policy of aggressive reciprocity were to prevent the Japanese from thus acquiring activities in which the U.S. would otherwise specialize (i.e., activities in which the U.S. would enjoy a comparative advantage if the Japanese can be prevented from artificially creating one). Then aggressive reciprocity may indeed benefit the U.S.

The possible effects on Canada of U.S.-Japan aggressive reciprocity

If the U.S. bilaterally applies aggressive reciprocity to the Japanese, Canada may benefit for two reasons:

– Some U.S. purchases may be diverted from Japan to Canada with increased export benefits to Canada. (Although this conclusion is reasonably assured, there would be some indirect costs to Canada of the lowered income and higher costs in Japan and the U.S. that might result from a trade conflict between the two.)

– Canada would benefit from this policy, if it were to be used instead of other forms of U.S. protection, which, though triggered by Japanese imports, may be applied to *all* U.S. imports. Such protection tends to damage Canada – in fact, it may damage Canada more than Japan.)

Unfortunately, however, a U.S. policy of aggressive reciprocity involves a number of possible costs for Canada:

1 Such a bilateral U.S. protective measure aimed at a specific partner would damage the multilateral principle of equal treatment to all MFN partners in Article I of the GATT. (For a small country, in a world of large countries, this is an important principle; it prevents large countries from concluding bilateral deals that exclude Canada and hence discriminate against Canadian exports.)

2 Aggressive reciprocity is based on a very special and controversial concept of equal treatment. In trade negotiations in the past, the

attempt, by and large, has been to equalize *changes* in protection; but, as already noted, this new concept of reciprocity attempts to equalize *existing levels* of protection. In other words, the U.S. would be raising trade barriers against trading partners whose levels of protection may not have changed at all; their only offence may be that their *existing* barriers are judged *by Americans* to be higher than those of the U.S.

3 Although the present target for this U.S. policy is Japan, it is easy to see how, once the precedent is accepted, this policy might be turned against Canada: In many industries, Canadian tariffs are higher than in the U.S., thus making us vulnerable to an American attempt to achieve 'reciprocity' by increasing U.S. barriers to our exports. (This is particularly important for Canada, because – as already noted – nominal equivalence of Canadian and U.S. trade barriers leaves Canadians at a disadvantage; hence there is a tendency for Canadian trade barriers to be higher than those of the U.S. – at least in a nominal sense, though perhaps not in the sense of their restrictive effect in blocking producers out of export markets.)

Effects on Canada of Canada/U.S. aggressive reciprocity

If the U.S. applies this policy to Canada rather than Japan, the effect on Canada would be entirely different. In particular, when the U.S. threatens its initial 'reciprocity' trade restrictions, Canada would face a choice: Give up the protective tariffs, export subsidies, and/or tax policies that have triggered the U.S. threat, or face possible U.S. action against our exports.

If we do give up these forms of protection, then in economic terms Canada may benefit or lose, depending on whether these policies have been benefiting Canada or not. (For example, are we having to give up an activity of 'create' comparative advantage in which we are about to reap external benefits? Alternatively, is this U.S. pressure just 'saving us from ourselves' – or more precisely, saving us from those groups in Canada that might otherwise be able to promote their own self-interest through protection and subsidies paid for by the public?)

On the other hand, if Canada were to ignore the U.S. threat and the U.S. does introduce these new trade restrictions, the result would be unambiguously damaging for Canada – even if the conflict were to end here. The efficiency costs for the relatively small Canadian economy would be substantial because reduced export sales would mean lost economies of scale. And Canada would face a terms-of-trade loss from any new U.S. tariff increase.

Moreover, if Canada were to retaliate, and an escalating trade conflict between the two countries were to result, Canada would be damaged even more. Because the Canada/U.S. terms of trade in manufactures is dominated by the U.S., any Canadian trade restrictions in manufactured goods would provide little relief from the adverse effect on our terms of trade from U.S. trade restrictions. In other words, with each round of protective thrust and counter thrust by the two countries in a trade conflict, Canada's terms of trade would, on balance, deteriorate. And, of course, economies of scale would be lost as exports were reduced. Finally, there would also be the familiar efficiency losses in consumption that would result from Canadian trade barriers, including the cost of a more restricted variety of products available to Canadian consumers.

If the Canadian trade restriction that 'keeps the trade war going' is an export subsidy, then the futility of this measure is transparent – especially if this Canadian export subsidy is set to offset a newly-imposed U.S. tariff. The Canadian export industry would be left unaffected, since its export subsidy from the Canadian government would just offset the new U.S. tariff it would have to pay. But there would be a large loss incurred by Canada, since the Canadian taxpayer (via the Canadian exporting firm) would be paying a duty to the U.S. that didn't exist before. Such a policy is clearly out of the question for another reason as well: the U.S. would be able to tax Canada at will simply by increasing its tariff.

Even if a trade war does not develop, any U.S. attempt to *bilaterally* monitor its trading relations has serious implications for Canadian sovereignty. While some Canadian sacrifice of sovereignty results whenever Canada signs trade agreements under the GATT, this sacrifice is more than made up for by our improved access to foreign markets (i.e., by the sacrifice of sovereignty by our trading partners when they also sign these agreements). But if the U.S. is attempting to partially replace the GATT in monitoring the world's trading system with aggressive reciprocity, the Canadian problem of loss of sovereignty becomes more severe. Our domestic policies that have unavoidable implications for our international trade – such as our programs that subsidize regional industrial development – would be monitored, not by a panel of the GATT, but by the U.S. This raises problems of sovereignty in any case, but especially so if the U.S. Congress becomes more protectionist.

In summing up the effects of U.S. aggressive reciprocity on Canada, the key question is 'Who is the U.S. target?' If the U.S. is using this policy on Japan, Canada may well benefit by picking up some of the broken pieces of U.S./Japan trade. But if Canada is the target, then the effects on us are likely to be damaging. In addition to the incursions by the U.S. on Canadian sovereignty (incursions which to some degree are inevitable in any important trading relationship, but which are now controlled at least to some degree by GATT 'due process') there would be substantial Canadian losses from reduced access to the U.S. market. These losses would become more and more serious were this dispute to escalate into a trade war.

I should now like to completely shift focus, from the economic policy (of aggressive reciprocity) that may be more likely than any other to dramatically sour the relationship between the two countries, to a policy that might, in an equally dramatic way, improve relations.

A CANADA/U.S. FREE-TRADE INITIATIVE IN MANUFACTURED GOODS? THE CANADIAN VIEW

The essence of the case for such an initiative is this: In manufactured goods in which there are economies of scale and other advantages of a large market, how can Canadian industrialists, producing in a domestic market of about 20 million people, compete with producers in Japan, the U.S. or Europe who have access to free-trade domestic markets of more than 100 million? By allowing goods to flow freely between the two countries, a Canada/U.S. free-trade agreement would provide Canadian producers and consumers with the benefits of a 'domestic' Canada/U.S. market of more than 200 million people.

In evaluating the effects of Canada in a more detailed way[6], it is important to distinguish between the effects on Canada of removing our own trade barriers against U.S. goods and the effects on Canada of the removal of U.S. trade barriers against our goods.

The effects of removing Canadian barriers against U.S. goods

This would reduce the price within Canada of imports from the U.S. (and of goods produced in Canada in competition with these imports). Moreover, with free entry into Canada, the quantity of imports would increase for two reasons, both beneficial to Canada: (a) Canadians would benefit from being able to increase their consumption of bargain-priced goods (both imports and import-competing goods); (b) To some degree, imports would displace higher cost Canadian production; we would be giving up the production of goods in which we have a comparative disadvantage in order to acquire them less expensively by importing them instead. (While employment in Canada would decrease as imports displaced some domestic production, there would be an offsetting tendency for employment to increase because our exports to the U.S. would increase as U.S. trade barriers came down.[7])

The effects of removing U.S. barriers against Canadian goods

1 Just as we noted earlier that a new U.S. tariff would cause a terms-of-trade loss to Canada, removal of existing U.S. tariffs would provide Canada with a terms-of-trade benefit. From the point of view of individual Canadian firms, this would manifest itself in the following way: At present, many Canadian industrial exports pay a U.S. tariff at the border which goes to the U.S. treasury. With the elimination of this tariff, Canadian exporters would no longer pay this 'tax' to Washington. In other words, the U.S. treasury would no longer collect this slice of income from Canadians. Instead, this income would be transferred back from the U.S. treasury to Canadian exporters and eventually to Canadian labour and other factors of production.[8]

2 Whereas the point above applies to *existing* Canadian exports, the removal of U.S. trade barriers would also provide another, much more important source of benefit to Canada – the opportunity for Canadian firms to *increase* their exports to the U.S. The resulting increased specialization in Canada in selected export lines where there are economies of scale would reduce manufacturing costs. This in turn would raise Canadian real income.

To sum up: With the elimination of trade barriers between the two countries, Canadian producers would rationalize – that is, specialize in a smaller range of goods, producing each at higher volume and frequently at lower cost. In doing so, Canadian producers would be responding to both a carrot and a stick. The carrot would be freer access to the large U.S. market. The stick would be the removal of

Canadian trade barriers, which would leave many Canadian firms unable to compete with less expensive imports unless they did rationalize and thus reduce their costs. The reductions in Canadian costs (that is, increases in Canadian productivity) would allow Canadian firms to be more competitive not only in the U.S., but also in third markets. And eventually, these productivity increases would allow Canadian producers to increase their wages and/or reduce their prices. (Indeed, inexpensive imports would force them to reduce their prices.) Thus, because of a combination of lower prices and increased wages, Canadian real income would rise.[9] Estimates of these and other Canadian income gains resulting from bilateral removal of Canada/U.S. trade barriers are very large – falling in the range of 5-10 per cent of Canadian GNP (see Harris and Cox, 1983, and Wonnacott's 1975 modification of the Wonnacott and Wonnacott [1967] estimates).

But with the increase in our income, would the activities in which we engage change drastically? Specifically:

Would Canadians become 'hewers of wood and drawers of water'?

It is true that removal of only our own trade barriers would move Canada in this direction, at least to some degree. The reason is that Canadian trade barriers (like those of other countries) are escalated, providing heavier protection to manufactured goods than to resources; and if only these barriers were to be removed, Canadian manufacturing would be likely to contract. While it is not clear that the resulting redirection of Canadian activity towards resource processing would be as damaging as Canadians sometimes assume (many oil exporting countries have discovered that 'drawing water' at $20-$40 a barrel can be extremely rewarding) almost no one suggests a policy of removing only Canadian trade barriers. Instead, the issue is removing both Canadian and U.S. barriers; thus we would be reducing U.S. trade barriers that are also escalated – and that have consequently deterred Canadian export and production of highly processed goods. (Since these goods encounter barriers at the U.S. border, we have tended to concentrate more heavily on exporting more freely traded primary products.)

In short, the Canadian tariff encourages us to concentrate more heavily on highly processed goods, while the U.S. tariff pushes us in the other direction, towards concentrating on resources. If both tariffs were removed – with their largely offsetting effects – it's not clear that we would move strongly in one direction or the other. Indeed, the existing Canadian industrial corridor between Windsor and Quebec City is a reasonably good location to produce highly processed goods for Canada/U.S. distribution – provided trade is completely free across the border. The reason is that this Canadian corridor lies along the northern edge of the largest market in North America – that is, the market in the Chicago/Boston/Baltimore triangle. In this respect, Toronto is a considerably better location than the 'out-of-the-way' Minneapolis-St. Paul area (which despite its distance, has nonetheless been able to attract and retain considerable industry in free trade competition with other U.S. locations.)

The problem of Canadian vulnerability

A Canada/U.S. free-trade agreement would be a much more irreversible option for Canada than for the U.S. (see, for example, Sharp, 1972, 15). The relative size of the two countries leads to this conclusion. In a fully rationalized North American economy, firms in the U.S. would have very limited dependence on Canadian markets (less than 10 per cent of the North American market is in Canada), while firms in Canada would be heavily dependent on the U.S. market. Accordingly, while the reintroduction of trade restrictions in such circumstances might do considerable damage to the U.S., it would involve a much heavier cost for Canada. Thus the threat of termination of a free-trade agreement would give the U.S. a bargaining lever that would be very difficult for Canada to resist and might conceivably be exercised to influence Canadian policy in quite unrelated noneconomic areas.

It is important to keep this problem in perspective. It is true that, in a free trade area, Canada would be hurt more by the reintroduction of U.S. protection. On the other hand, this is less likely to occur, because a free-trade treaty would more strongly bind the U.S. against imposing trade barriers against Canada. Thus it is by no means clear that our vulnerability (in the sense of 'expected loss') would be any greater than at present. But, in any case, it is important that as strong guarantees as possible against the reintroduction of U.S. protection be written into the treaty. One important measure would be to formalize the August 1971 precedent. Thus, if the U.S. felt that it must impose surcharges to defend itself against balance-of-payments difficulties, these should be limited to U.S. imports on which a duty is already being paid, with Canada consequently escaping such measures. In fact, far from hurting Canadian producers, such an increase in U.S. protection would benefit Canadians because it would increase our preference in the U.S. market over the Europeans and Japanese. Thus the expectation is that the imposition of U.S. surcharges (with Canada exempt) would paradoxically involve a cost for third countries, and for the U.S. (for the standard reasons that any country is likely to be damaged by its own protection) but a benefit to Canada.

In short, in a free trade area, Canadian vulnerability to changes in U.S. commercial policy – and hence to U.S. political pressure – would be increased in one sense (we'd be trading more) but reduced in another (the U.S. would be less able to impose barriers against our exports). It is not clear on balance whether we'd become more or less vulnerable. What is certain is that we would still have major problems in getting along with the U.S. – as we do today.

CANADA/U.S. FREE TRADE: THE U.S. VIEW

Many of you here today from south – or west – of the border are more qualified to comment on this than I am, but let me venture a few thoughts to get the discussion going.

Costs: the loss of tariff income by the U.S. treasury

With Canadian exporters no longer having to pay duty to the U.S. treasury, there would be a clear terms of trade benefit to Canada, as earlier recognized. But this benefit to Canada would, of course, also represent a loss to the U.S.[10] While this benefit to the relatively small Canadian economy might be important, the corresponding loss to the much larger U.S. economy would be of far less relative consequence. Past history suggests that Americans have never even noticed their loss of duty revenue from policies that have liberalized their trade with Canada.

Economic benefits for the U.S.

With the exception of a number of friendly overtures, there has been no serious recent attempt by either Congress or the U.S. administration to promote the idea of Canada/U.S. free trade. This reflects the correct perception by Americans that such a U.S.

initiative would politically kill the idea in Canada; it does not reflect an absence of benefits for the U.S. For example:

An expanded market

Removal of Canadian trade barriers against U.S. goods would expand U.S. markets, in the process providing gains to U.S. producers able to exploit comparative advantage and/or economies of scale. But such free access to Canada would expand the market available to U.S. firms by less than 10 per cent; would this generate significant benefits?

To get some idea of why the answer is likely to be yes for many U.S. firms, suppose that 5-10 per cent of the U.S. market lying northwest of a line running from, say, Minneapolis-St. Paul to Northern California were to be cut off from the rest of the U.S. by exactly the same trade barriers that now exist between Canada and the U.S. Even though this would be a geographically dispersed, relatively small part of the U.S. market, its loss would be important for many firms in the rest of the U.S., and crucial to some – especially those that would be just able to reach (or could not quite reach) their break-even point before taking into account their sales in this slice of the market. Yet the costs from this 5-10 per cent decrease in their market would be roughly the same as the benefit they would acquire from the 5-10 per cent increase in their market that they would get from free access to the Canadian market under Canada/U.S. free trade. In both cases, we are talking about the potentially large change in the profit position of U.S. firms that could result from a geographically dispersed 5-10 per cent change in the size of their free trade market.

Such a potential benefit to U.S. firms could exist even if their costs of production were constant. In areas of manufacturing where there are economies of scale, increased sales volume would mean lower costs on *all* their units of output, and consequently even greater potential benefits.[11]

The U.S. advantage of exporting to Canada vs. branch plant production there

Historically, the Canadian tariff has reduced the incentive of U.S. firms to export to Canada, and has thus increased their incentive to service the Canadian market by investing in Canadian branch plants instead. Accordingly, removal of this tariff will, in the long run, induce U.S. firms to export more and invest in Canada less. Given the recent uncertainty about the future climate for foreign investment in Canada, U.S. firms may prefer this export option on both political and economic grounds. A key question is: How much will the reduction in U.S. investment in Canada to service the Canadian market be offset by the increase in U.S. investment in Canada to service the whole North American market?

Reduced risk to U.S. trade and investment in Canada

An approach by Canada to set up a free trade area would leave the U.S. with the choice of saying yes or no. But whereas a yes would draw the two countries together, a no would be likely to push them apart. Indeed if the Canadian approach occurs when, because of increased U.S. protection, Canada views the status quo as no longer an option but has to choose between greater cooperation with the U.S. or a more protective nationalistic approach, then a U.S. refusal would essentially guarantee a Canadian move in this protective, nationalistic direction.

Thus there are two broad economic reasons for the U.S. to favourably respond to a Canadian initiative: the first is that it would provide benefits; the second is that it would reduce the risk to the U.S. of losses on its exports and investments in Canada if a rebuffed Canada embarks on a more nationalistic set of policies.

While the picture is one of net economic gains for the U.S. that might be large in absolute terms, it isn't clear that they would be large when measured as a percentage of the huge U.S. GNP. But so long as the economic effects are positive – no matter how small – this should be more than enough, given the past U.S. record of accommodating to the wishes of its trading partners. For example, the U.S. supported the formation of the EEC, *even though* this policy – and in particular, the highly protective Common Agricultural Policy – involved substantial costs to the U.S.[12] American support in this (and in other cases) has been forthcoming for political reasons – and there is no *a priori* reason to expect that similar support for a Canada/U.S. free trade area would be withheld.

Political advantages for the U.S.

While U.S. support for the EEC was tempered by the possibility that the EEC might make Europe more protectionist, there is no such problem in the proposal considered here: Canada/U.S. free trade would, by its very nature, make Canada a *less* protectionist partner. Given the number of hostile relationships that the U.S. already has to deal with, a strong political case can be made in the U.S. for a policy of accommodating a key partner – a policy that should increase the chance of future cooperation, rather than conflict.

But the incentive for the U.S. may be more than just the defence of an existing relationship. It is possible that the two countries might view a Canada/U.S. free trade area as a focus for a broad new initiative to 'get North America moving again'. The task of revitalizing Canada/U.S. industry would be encouraged by an important (and paradoxically protective) side effect of a free trade area: industry in each country would get protection from third country competition in the market of the other country. (For example, in selling in the U.S., Canadian producers would get duty-free access that third countries such as Germany or Japan would not enjoy. Similarly, U.S. producers would get preference in the Canadian market vis-à-vis third country competitors.) Because tariffs are escalated – i.e., higher on industrial products than on primary products – this 'market trading' effect would be stronger in highly processed industrial goods than in primary products.

Thus, there is a reasonable expectation of a favourable U.S. response to a Canadian initiative. But there is, of course, no guarantee. Negotiations we enter into are never guaranteed of success. The normal procedure is for a country to decide what is in its interest, and then attempt to negotiate it.

A CANADA/U.S. FREE TRADE INITIATIVE: OTHER ISSUES

Timing

The longer we delay in reducing Canada/U.S. trade barriers, the longer Canadian industry – and especially those firms that have already expanded to service the U.S. market – will be encumbered directly by U.S. trade barriers and indirectly by Canadian trade barriers. (Canadian trade barriers have a complicated effect on any specific Canadian industry. Although the industry's *own* barriers protect its output sold in Canada, this is partly offset – in some cases, more than offset – because its costs are raised by Canadian trade barriers on its inputs.)

However, no matter how quickly we move now, it is difficult to see how a free trade agreement could be negotiated and initiated before the current Tokyo Round of tariff cuts is completed in 1987. Moreover, this timing is consistent with the two countries invoking the 'interim agreement' rather than the 'declaratory' procedure under article XXIV of the GATT.[13] (Under the interim agreement formula, Canada and the U.S. would submit a plan and schedule to the GATT for the creation of a free trade area. This would inform other GATT members, and allow them to make recommendations. This is the procedure that has been used by other applicants in the past; in none of these cases have formal recommendations been made by excluded countries.)

If tariff cuts were to be thus initiated in 1987 and stretched over a 10-year period, Canadian protection would not be removed until late in the 1990s. Accordingly, the problem for Canadians would not be so much losses on existing assets as getting the next generation of capital investment pointed in the right direction.

Minimizing adjustment costs

Precedents – such as of EFTA and the EEC, along with the Kennedy and Tokyo Rounds – suggest that dislocation costs from reducing trade barriers may be less than expected. Moreover, such adjustment costs must be kept in perspective. Over time we are incurring more and more of these costs simply in an attempt to maintain the status quo. Even if we freeze our trade policy (which, in practical terms, does not mean freezing our tariffs, but instead means cutting them to the levels agreed upon in the Tokyo Round) we will still face an increasing problem of adjusting, not only to the lower (Tokyo Round) levels of protection, but also to the increasingly rapid changes in technology and trading patterns that are occurring – in particular, the explosive penetration of our market by producers in the Far East. In the face of such dramatic changes – along with the gyrations in floating exchange rate that now occur – it isn't even clear that the relatively modest Canadian tariff cuts of between zero and one-and-one-half per cent *per annum* that would be required in moving to a Canada/U.S. free trade area would even be greatly noticed.

But having said this, it would still, in my judgement, be very important to take special precautions, especially on the Canadian side of the border where most of the adjustment to Canada/U.S. free trade would occur. Before turning to specific recommendations for making the adjustment easier, it should be noted that there are two existing buffers that should help to reduce the short-run adjustment costs. The first is our flexible exchange rate. This would provide some braking mechanism against a rapid influx of imports into Canada and a loss of employment here. (Should such developments occur, the result of course would be a reduced value of the Canadian dollar, which would in turn stimulate Canadian exports and employment, and limit the influx of imports.) Second, U.S. multinationals in Canada may also make the adjustment easier, since they already have the facilities for distributing any newly specialized output of their Canadian plants throughout the U.S.

What are the additional ways to buffer the Canadian economy from severe adjustment costs?

Import trigger points

One approach to consider is a variation of the Swedish/EEC free-trade triggers that would allow Canada or the U.S. to invoke controls on imports if they exceed an agreed-upon growth rate. Such a brake on imports would prevent a too-rapid displacement of employment in either country. (But Canadians should recognize that such symmetric provisions may be invoked by the U.S. – just as the EEC has invoked this mechanism against rapid imports from Sweden.)

Employment or value added guarantees for Canada

The more specific the attempt to protect existing Canadian employment patterns, the greater the administrative difficulties. Many of the problems encountered under the Auto Pact – plus some new ones – would have to be faced, were we to attempt to provide value added or employment protection in a broader, across-the-board free-trade arrangement.

But if this approach is taken, any such guarantees should be short-term, with a clearly defined termination date. Otherwise, they would tend to block the shift of activity towards our sectors of comparative advantage and could generate severe problems in controlling the wage level. Short-term guarantees are probably the most we could negotiate in any case (indeed we might be lucky even to negotiate these) because of U.S. dissatisfaction over misunderstandings arising from the Auto Pact guarantees (were they temporary or permanent?);

and because, unlike import trigger points, such guarantees would be asymmetrical – providing protection to Canada but not to the U.S.

Indeed, as a condition for conceding such guarantees, the U.S. might seek to broaden the agreement to provide itself with some assurance of access to future Canadian resource supplies. For example, the U.S. might seek the right of first refusal on a substantial quantity of our future resource exports – at the then prevailing world price. Such an assurance would involve essentially no cost to Canada, since the U.S. is likely to be our largest export market anyway, and we would be getting the full world price. The interesting aspect of this diplomatic trade is that the two countries might mutually benefit by reducing each other's risk: Canada would help the U.S. to reduce its resource risk, while the U.S. would, as a *quid pro quo*, help to reduce Canada's trade liberalization risk by allowing some short-term employment or value added guarantees.

Adjustment assistance

This can take many forms: government-backed loans, special R&D grants, or accelerated depreciation for Canadian firms rationalizing in order to expand into the U.S. market.

How would such measures be financed? One suggestion is this: as the Canadian tariff is reduced, prices in Canada will fall. The government could capture part of this price reduction with a temporary sales tax that could then be used to subsidize Canadian industry through the adjustment period. In this way, some of the short-run adjustment costs of Canadian industry would be paid for by the Canadian consumers who benefit from the tariff cuts.

Any such subsidies would have to be explicitly recognized as part of the agreement and therefore exempt from U.S. countervail. No such problem would be involved in subsidies paid not to firms, but instead to people who have been displaced – such as portable wage subsidies and retraining grants. Such temporary subsidies would be the essential bottom line in any broad program of adjustment assistance.

Competition policy

In order to facilitate the rationalization of Canadian production in response to free-trade incentives and pressures, Canada should relax its restrictions on mergers of firms producing traded goods. (In these products, adequate protection against monopoly abuse would be provided by the competitive pressure of increased imports.)

A monitoring agency

For such a broad agreement, an agency to handle disputes and appeals would be essential. (A number of misunderstandings and complaints might have been reduced or avoided, had such an agency been established for the Auto Pact.) Canada should seek an agency with equal representation from the two countries that would make binding decisions on matters of appeal – even though (as in any other binding international agreement) this would involve some sacrifice of autonomy. The problem is that the U.S. would also be sacrificing some autonomy, so it's not clear that such a strong monitoring agency could be negotiated. A more realistic expectation might be for an agency that would make strong but nonbinding recommendations to the two governments.

Further observations

Since much of the short-run risk and adjustment cost from free trade would have to be borne by Canadian manufacturers, they have traditionally been one of the strongest sources of opposition. But there is now evidence that this opinion is shifting. In a 1980 presentation to the Senate Standing Committee on Foreign Affairs, the Canadian Manufacturers' Association reported on the roughly 1,000 replies to a nationwide survey of its member firms on the question: 'What would be the net impact on your company of Canada/U.S. free trade?' The answer: roughly one-third of the responding firms expected to contract, about one-third expected no change, and about one-third expected to expand. This apparent neutrality of Canadian manufacturers seems to represent a surprising change from two decades earlier when, at least in our casual observation, business opposition far outweighed support. (This questionnaire result was even more remarkable, because it did not provide a greater weight to larger companies; and they, on average, more heavily favour trade liberalization.)

There is good reason to view this (at least) neutral response as a strong confirmation of the case for free trade. Manufacturing executives – together with labour – are the ones who have to face the risks. And if these risks are judged to be offset by expected benefits, then we are left with the essentially undiluted benefits that would go to other sectors of the economy; for example, to consumers facing lower prices and to resource producers facing lower input costs.

Finally, let me observe that, if we are to take an initiative, there are two good reasons for doing it now. First, the longer we defer, the more opportunities will be missed. (True, rapid technological advances have made entry possible into certain activities in well-established industries. But there are many economies-of-scale industries that we can break into only when they are being born, but not later, when large firms have become established.)

The second argument for an initiative now is that it may well be more difficult in the future – especially if we wait for a favourable political climate in Canada. Paradoxically, such a favourable Canadian climate of opinion is most likely to occur if and when there is a strong resurgence of U.S. protectionism that seriously threatens our access to the U.S. market. In such circumstances, the status quo would disappear as an option for Canada, and we would have little other option (short of a costly South-American style shift to a more protected and isolated economy) but to seek some form of bilateral trading accommodation with the U.S. But because of the revived U.S. protectionism, this would be the worst time to try to negotiate freer trade; it would be even more difficult than it is today to get U.S. agreement on provisions to reduce Canadian adjustment costs.

NOTES

1 This section draws heavily on Bergsten and Cline (1982) and especially Cline (1982). It also draws on, and reports some of the conclusions in my recent report for the Institute for Research on Public Policy (1983).

2 The view that, relatively speaking, the U.S. is a less protected economy than Japan is disputed by Cline (1982) and Saxonhouse (1983).

3 The term 'infant protection' is here used in a broad sense. Traditionally, such protection was designed to nurture an infant that might not otherwise survive competition from *existing* producers in other countries. Here it can mean this, *or* the nurture of an infant to ensure that it survives competition from *simultaneously* emerging (or even lagged) infants elsewhere.

(When we speak of this sort of infant protection, we include not only import barriers but also domestic or export subsidies.)

4 Why don't such future profits lead to the *unsubsidized* development of this activity? The traditional answer has been the failure of capital markets to provide the necessary funds up front.

Part of this future profit may be realized because the targeted Japanese firms may be able to capture sales and monopoly rents from, say, competing U.S. firms. According to an analysis developed by Brander and Spencer (1981 and 1983), this rent-capture may more than compensate the Japanese for the contemporaneous losses they incur from infant protection.

5 See Bergsten and Cline (1982), and, for much more detail, Diebold (1983).

6 For much more information on this proposal, see the Senate Standing Committee on Foreign Affairs' recommendation of a Canada/U.S. free-trade area in *Canada/United States Relations, Vol. III: Canada's Trade Relations with the United States* (Ottawa, 1982); and *Looking Outward* (Ottawa, Economic Council of Canada, 1975). In this abbreviated summary of the issues, these sources – along with previous writings by the author – have been heavily drawn upon. For reservations about a Canada/U.S. free-trade area, see B. Wilkinson, 'Canada/U.S. free trade and some options, *Canadian Public Policy*, October, 1982.

7 There would be a trade diversion cost to Canada to the degree that we switched our import purchases from less expensive third countries to the U.S. However, this could not occur in the large bulk of our imports, because they are already purchased from the U.S.

8 Since removal of the U.S. tariff would transfer income from the U.S. to Canada, why wouldn't removal of the *Canadian* tariff transfer income in the other direction – from Canada to the U.S.? Technically, the answer has been given in our earlier discussion: because of its relative size, it is the U.S. rather than Canada that determines the terms of trade in manufactured goods between the two countries. Therefore, the terms of trade between the U.S. and Canada are substantially affected by a change in the U.S. tariff, but little by a change in the Canadian tariff. To state this in another way: because the prices of industrial goods are typically set in the large U.S. economy rather than the small Canadian economy, Canadian importers who accordingly must take the U.S. price as given, must raise the price of imports as they come into Canada by the amount of the Canadian tariff. Thus the Canadian tariff collected by Ottawa is paid by Canadians (namely, Canadian

consumers who pay a higher price). In other words, the Canadian tariff transfers income *domestically* – from Canadian consumers to the Canadian treasury. This is quite different from the U.S. tariff which transfers income internationally – from Canadian producers to the U.S. treasury.

9 The specific way in which the real income gain would manifest itself (i.e., the specific combination of price reductions and wage increases) depends on, among other things, the degree to which the Canadian dollar is allowed to float.

10 There is another reason why the U.S. treasury would lose duty revenue. Americans would be diverting some of their import purchases from a cheaper source (such as Europe or Japan) to Canada. Imports from Canada would pay no duty, whereas previous imports from Europe or Japan did.

11 Whereas U.S. firms would be expanding in most lines of activity, in some they would be contracting because of new Canadian competition. But the expectation of benefits remains, a point that may most clearly be seen by considering a firm manufacturing ten products at roughly a break-even point on each. Suppose, as a result of trade liberalization, that it has to give up one of its break-even activities, while expanding its other nine. On these nine it makes a profit where none existed before.

12 The only way of arguing that the EEC provided net benefits to the U.S. is to argue that it generated a much more rapid rate of European growth (and hence more purchases from the U.S.) than would have occurred otherwise. But this is very speculative territory, since we simply don't know what would have occurred otherwise. It is for this reason that we have not used a parallel argument – i.e., that the U.S. would benefit from more rapid Canadian growth in a Canada/U.S. free trade area. Incidentally, there is a stronger argument of this sort in the Canadian than in the European case; estimates of the static real income gains for Canada fall in the range of 5-10 per cent or more, while estimates for the EEC fell in the range of 1 per cent or less.

13 Under the declaratory procedure, the two countries simply declare that a free trade between them *already exists*. By 1987 when the Tokyo tariff cuts are complete, it has been conservatively estimated that 80 per cent of Canada's exports to the U.S. will be duty free, as will 65 per cent of our imports from the U.S. While this is not nearly as close to free trade as it is now fashionable to believe, it is still closer than other regional groups have been when they formed free trading arrangements in the past without GATT objection. Hence Canada and the U.S. could be deemed to

qualify under this clause. But the problem with this procedure is that it may well be viewed by other GATT members as 'too cute' for such important trading nations to invoke; and these members might accordingly object to Canada/U.S. NTB liberalization, which is not covered by this declaratory GATT procedure. (Such NTB liberalization is essential, and *is* covered by the interim agreement formula recommended here.)

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Comments

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As Ron Wonnacott rightly stresses, recent trends in U.S. trade policy hold the possibility of not only significant market losses for Canada but a loss of Canadian sovereignty. The particular policy about which he is concerned is the proposal to apply a new concept of reciprocity. Instead of measuring reciprocity in terms of balanced changes in levels of protection, as we have traditionally done, the new concept measures reciprocity by comparing the absolute levels of protection between the United States and another country. To use a favourite phrase in trade policy circles, the new approach seeks a 'level playing field' for U.S. participants in the competition for international markets and regards reciprocity as being attained only when the playing field is level.

Besides this new concept of reciprocity, there are several other developments in U.S. trade policy that are of considerable concern to Canada as well as the rest of the trading community. These include:

- a much greater willingness to implement the so-called 'fair trade' rules of U.S. law and the GATT, particularly in the area of government subsidization of various forms;
- a new willingness to bypass GATT procedures and counter foreign export subsidies in third markets with U.S. export subsidies in these same markets;
- a willingness by some officials to abandon the traditional U.S. support for the most-favoured-nation (MFN) principle and to accept the concept of selectivity in protecting industries injured by import competition; and

– an acceptance by some political leaders of the appropriateness of a comprehensive industrial policy approach to promoting new products as well as to underwriting the viability of certain basic industries faced with severe international competitive pressure.

These developments are, I think, a manifestation of a fundamental change in the attitude of U.S. trade policy leaders that has created a significant disequilibrium situation with regard to the trade policy environment between the United States and such countries as Canada. Although there is clearly a protection component in the changed trade policy outlook, to describe it only as a shift toward protection fails, I think, to capture its full implications. Ron Wonnacott gets at the basic nature of the change that is taking place by using the term 'aggressive' to describe the new reciprocity concept. We are witnessing a more aggressive U.S. approach both to reactive trade policy aimed at mitigating the negative income and employment effects of external shocks to the trading system and to active trade policy designed to generate new jobs and higher income levels by taking advantage of changing international economic conditions. Since this new approach has very significant implications for Canada as well as the rest of the trading community, I should like to discuss briefly how it has developed and what it might mean for future Canada/U.S. trade relations.

Basically, I tend to agree with the formulators of the hegemonic model of regime change who stress the dominant international economic position of the United States in the early post-World War II period, as well as the country's subsequent decline from this position, to explain both the openness of the international trading regime during the first period and the gradual deterioration in the system as U.S. international competitiveness decreased. An open trading regime based on the MFN principle has some of the characteristics of a public good. Because of nondiscriminatory tariff reductions, it is sometimes difficult to exclude a particular country from the benefits of openness even if the country does not fully contribute to the openness by keeping its own trade barriers low. To some extent, exclusion can be accomplished if those countries that do participate in making the system open maintain high trade barriers against the products of nonparticipants in which the nonparticipants are the principal suppliers in world trade. However, small countries are not principal suppliers in many product lines and thus it is in their interests to try to get a 'free ride' on the trade-liberalizing efforts of other countries. However, large countries cannot follow this practice, since they each tend to be principal suppliers to other large countries to the same extent that the other countries are to them. They must, therefore, reduce their own trade barriers to obtain meaningful trade concessions from other large countries.

Immediately after World War II the United States emerged as the dominant trading power, as Japan and the European countries struggled to reach their prewar production levels. For example, in 1952 the U.S. share of exports of the major industrial nations was 35 per cent, in contrast to only 21 per cent in 1938 and 1928. The export surpluses that emerged in almost every major product category not only masked the underlying competitive weaknesses in such lines as textiles, but served to build a broad base of support for seeking tariff cuts from other nations in return for reciprocal cuts by the United States. U.S. multinationals that wished to invest abroad also pushed for an open trading system as a means of enhancing the profitability and security of their foreign undertaking. Furthermore, the foreign policy goals of the United States played a key role in shaping U.S. trade policies. It was widely believed that the communist countries posed a serious economic and political threat to the United States, its allies, and the rest of the market-oriented economic world, and that economic assistance in the form of economic grants and lower U.S. trade barriers was an essential element in countering this threat.

Not only do these various factors account for the vigorous efforts by the United States to reduce tariffs on a multilateral basis but they explain why the United States was willing to accept extensive free-riding and lack of full reciprocity on the part of other countries. It was evident to all, for example, that the existence of foreign exchange controls in Europe until the late 1950s vitiated much of the trade-creating benefits to the United States of the cuts in European tariff levels. Equally important was the U.S. policy of not strictly enforcing U.S. and GATT rules dealing with foreign subsidies and other so-called unfair trade practices. It became increasingly evident, for example, that subsidies by foreign governments were not only offsetting the trade-creating value of their duty cuts but were artificially increasing their exports to the United States. Yet, despite strong objections from certain domestic producers, retaliatory measures were not adopted because of the preeminence of foreign policy considerations.

Significant changes in U.S. international economic and political priorities began to be evident by the late 1960s. The importance of trade policy as a domestic political issue increased, while the importance of trade policy in promoting foreign policy objectives declined. The increased significance of trade policy as a domestic issue was closely related to the decline in dominance of the United States as a trading power. The U.S. share of exports of the 15 largest industrial countries fell from 25.2 per cent in 1960 to 22.5 per cent in 1970 and then to 18.3 per cent in 1979. Further, the general decline in U.S. competitiveness has been accompanied by the emergence of severe structural problems in a number of politically powerful sectors. At first these consisted mainly of labour-intensive sectors such as apparel and footwear, but more recently they have included capital-intensive and skill-intensive industries like steel and autos. In the foreign policy field, the decline in Cold War tensions during the 1970s and the reevaluation of the country's military role in the world acted to reduce the importance of trade policy as a foreign policy tool.

A consequence of the decline in U.S. hegemony has been the adoption on the part of U.S. trade officials of a more inward, nationally-oriented view of trade policy issues. No longer are they willing to ignore what they regard as the free rides and chiselling on GATT rules of others in return for vague foreign policy objectives. More importantly, they believe that the existing regime has been operating in a manner that works to the disadvantage of the United States. During the Tokyo Round of multilateral negotiations in the mid-1970s, the strategy pursued in attempting to offset these disadvantages was to press for new codes of international conduct within the GATT that would force other countries to follow more closely what the United States regards as good behaviour in international trade. However, while improvements in the rules were made, the enforcement of the new codes has proved to be disappointing to U.S. trade policy officials. The panel procedure has continued to be cumbersome and not very helpful in bringing about significant changes in policy.

This has left U.S. officials in a somewhat schizophrenic position. Most think that a strict and general commitment to GATT rules is still the best course to follow for all countries. However, being disappointed by the failure, in their view, to secure adequate enforcement of these rules, either through direct negotiations or the GATT panel procedure, they believe that the only way this can be achieved is for the United States itself to pursue an aggressive strategy of imposing countervailing duties and introducing countervailing subsidies. The objective would be to discourage trade practices that are inconsistent with the spirit of the rules of the GATT by offsetting the short-run gains from such practices. But there are also some officials who feel that this approach is not likely to achieve its objective. These individuals argue that the United States should itself adopt the subsidizing and trade-restricting practices of other countries. The aim would not be to force these countries to the negotiating table to develop better ways of enforcing existing GATT rules but simply to outdo these countries at their own practices by using the superior resources and market power of the United States. Adopting a comprehensive industrial policy approach is an example of this strategy.

The perception of many in the U.S. trade policy community that GATT rules are not being properly enforced and, therefore, that the present international trading order is working to the disadvantage of the United States may or may not be a correct one. But it is a viewpoint that is beginning to shape U.S. trade policy behaviour along lines quite different from those of the recent past and that may bring about considerable turmoil in international trade. It could lead to a sequence of retaliatory actions between the United States and other countries that increased rather than decreased the degree of economic distortion in world trade. For example, recently the European Community (EC) has announced an increase in its export subsidy on wheat flour as a response to the export subsidy to wheat flour provided by the United States. The U.S. subsidy was itself introduced to offset the trade advantage in third markets obtained by the EC because of its export subsidies, and thereby to induce the EC to reduce its export subsidies on agricultural goods. Similarly, if the United States adopts an industrial policy involving significant subsidies to domestic industries, other countries might simply increase their own subsidization with no net advantage being obtained by any trading nation.

The best course of action for all as a group would be to try to resolve the differences in the interpretation of GATT rules through negotiation and the GATT panel procedure. Unfortunately, the outcome of the GATT Ministerial meeting in November 1982 does not make one very sanguine about the prospects for this route being followed. But clearly we must continue to press for this approach. The most likely course of international trading relations, in my view, is one in which there will be increased subsidization, counter-subsidization, and the use of countervailing duties and quotas over the next several years until there is a greater appreciation by the large and small participants that the costs of maintaining an open international order must be shared to a greater extent if all are to benefit from the regime.

This change will, I think, be the consequence of the decline in U.S. hegemony and the emergence of a state of affairs in which there are three major trading powers, namely, the United States, the European Community, and Japan, rather than one super trading power. However, unlike some of the formulations of the hegemonic theory of regime change, I do not believe the change will produce a complete breakdown in the trading order. There will be more turmoil for a period of time, but the three major powers do seem to appreciate the benefits of the system sufficiently to keep the basics of the system together. However, in the process of moving to a new equilibrium some of the smaller countries like Canada may fare poorly.

How does the new U.S. attitude toward trade policy affect the U.S. view towards the proposed free-trade arrangement between the United States and Canada in manufactured goods? As Ron Wonnacott points out, such an initiative would bring long-run economic benefits to both countries and strengthen political ties between the two nations as well. Unfortunately, I think that the new U.S. attitude makes the United States less receptive to the proposal than formerly. For example, as I noted previously, there is now a much greater awareness that nontariff measures not covered by a free-trade agreement can offset the benefits of duty reductions. Specifically, Canadian subsidies to domestic firms or foreign affiliates might increase and thereby lessen the extent of the increased exports from the United States. U.S. trade officials are also greatly concerned about the performance and establishment requirements for U.S. firms investing in Canada, and it is unlikely that they would accept a free-trade agreement without some understanding about the future nature of these requirements.

The provincial governments in Canada, like the state governments in the United States, also apparently have considerable power to subsidize industries as well as to restrict investment in their regions.

It seems to me that U.S. officials will insist that an understanding be reached that in some way includes such activities by the provincial governments. As Ron points out, a major appeal of a free-trade agreement for the United States would be greater access to Canadian supplies of nonagricultural primary products. Consequently, U.S. officials are likely to want to be sure that actions by provincial governments or nontariff measures introduced by the federal government do not offset the greater access to Canadian resource supplies.

It is also hard to see how some understanding concerning Canadian policy toward U.S. direct investment in Canada can avoid being part of an acceptable agreement. Investment and trade are very close substitutes between neighbours such as Canada and the United States. I suspect that differences in social welfare and tax policies and even such matters as immigration policy will also become part of any negotiation aimed at bringing the two nations closer together. Such highly protected U.S. sectors as textiles, apparel, footwear, and various miscellaneous product lines are bound to feel threatened by lower cost labour in Canada due to what they are likely to regard as an unfair advantage based on different social policies.

Canadian firms could also be hurt by various nontariff measures introduced by the United States after an agreement covering only tariffs on manufactured goods. For example, if the U.S. pursues the industrial policy approach with significant subsidies to certain domestic industries, Canadian firms that had captured a share of the U.S. market in these sectors could suffer serious injury. The matter of U.S. countervailing duty action that Ron Wonnacott raises is also a matter that should be faced prior to any agreement.

In short, while I favour special economic relations between the United States and Canada, I wonder if we can and should restrict these just to mutual zero-duty treatment for manufactured goods. The increased awareness on the part of both Canadian and U.S. officials of the effects of domestic fiscal and monetary policies as well as exchange rate policies on trade flows and, in particular, the belief by many U.S. officials that these policies have been used by other countries to erode U.S. trade benefits under the GATT are likely to make it impossible simply from a practical political viewpoint to confine any Canada/U.S. trade negotiation only to the issue of tariffs. Would it perhaps not be better to work for a more comprehensive agreement that covered some of these other policies and yet did not undermine the essential degree of sovereignty of each nation?

Comments

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Introduction

As the participants at this conference are well aware, the Canada/U.S. trading relationship remains the largest and most extensive of any two countries in the world. In 1982, total two-way trade exceeded $80 billion. Because of the vital political and economic links between our two countries, President Reagan, upon entering office in January 1981, placed a high priority on improving relations with Canada and working with the Canadian government to promote expanded trade and better bilateral economic relations.

Unfortunately, as we all know, the new Administration found itself in the midst of a deteriorating bilateral economic relationship with Canada as a result of efforts by the Canadian Government to enhance Canada's national identity and the role of Canadian enterprise in the Canadian economy. While the United States respected these efforts, they unfortunately were being pursued in a discriminatory manner, at times inconsistent with Canada's international commitments.

The underlying cause of the tension in our bilateral economic relationship during that period was the result of significant differences in our two government's approaches to economic questions. The Reagan administration entered office advocating a free market approach to trade and investment. A commitment to maintaining free markets was a central element in the President's domestic economic program.

On the other hand, the Trudeau government was advocating a much more interventionist approach to economic issues. Nationalism, which translates into increased Canadian control of the economy, was the basic theme of the Canadian government's economic program. However questionable that theme may have been from the standpoint of the Reagan administration's economic philosophy, there was no question of the sovereign right of Canada to 'Canadianize' its own economy. The main U.S. concern was with a number of the policy measures that the Canadian government proposed in order to achieve that objective.

Today, the Canada/U.S. trading and investment relationship is on a more positive footing. The Trudeau government, perhaps as a result of its domestic economic and political problems, is attempting to better manage the trade irritants which inevitably occur between such large trading partners. However, many of the trade policies of the Trudeau government which caused such an uproar in the 1980/1 period are still in place. In addition, even during the more recent period of 'improved' Canada/U.S. trade relations, protectionist policies continue to be implemented by the Canadian government. Let me briefly describe some of these policies.

National Energy Program

Canada's National Energy Program (NEP), announced in October 1980, remains substantially unchanged today. Its discriminatory provisions, such as the Petroleum Incentives Program (PIP), and its retroactive provisions, the 25 per cent 'back-in', continue to be of serious concern to the United States. From a trade perspective, U.S. concerns centre on the operation of the Canada Oil and Gas Lands Administration (COGLA) and the Committee on Mega-Projects Industrial Regional Benefits (CMIRB) where reports of pressure being exerted on foreign firms to procure goods and services from Canadian sources have been reported. Such practices would be a clear violation of Article III of the General Agreement on Tariffs and Trade (GATT), the national treatment provision. These reports continue today.

Foreign Investment Review Agency

The Canadian Foreign Investment Review Agency (FIRA) was established in 1973 to increase Canadian control and ownership of investment in Canada and to ensure benefits for Canadian firms from such investment. U.S. concerns over FIRA were not aimed at its existence or its screening of new foreign investment, but certain aspects of its administration. Particularly troublesome are the legally enforceable commitments exacted by FIRA from firms investing in Canada, such as specifying when firms must purchase Canadian goods and/or requiring firms to export a specific share or volume of its Canadian production. The U.S. initiated a GATT complaint against these FIRA practices which is still outstanding. In addition, FIRA's veto power over the transfer of Canadian assets from one foreign owner to another is of great concern to us.

The administration of FIRA has improved significantly over the past year since the appointment of Ed Lumley as the Minister responsible for FIRA and Bob Richardson as its administrator. Processing time for applicants is much improved and other bureaucratic problems have been minimized. However, it should be emphasized that the FIR Act remains unchanged, and the serious problems associated with FIRA in 1980/1 could easily reappear should different personnel with nationalist tendencies take over the administration of FIRA.

Border broadcasting

In 1976, Canada adopted a tax provision denying Canadian enterprises tax deductions for the cost of advertising in foreign media when the advertising is directed primarily at Canadians. The main targets of this legislation were ads placed on U.S. television stations beaming into Canada. Years of government-to-government and industry-to-industry consultations failed to provide a compromise solution. The U.S. administration, as a result of an investigation and determination under Section 301 of the Trade Act of 1974, has proposed mirror legislation to the U.S. Congress, but until now it has never been acted upon. In March of this year, the United States proposed a new compromise which would have reinstated the tax deduction for a certain percentage of the advertising placed in the United States based on the percentage of the border stations' audience share which is accounted for by U.S. viewers. Unfortunately, the Canadian government does not appear interested in reaching a compromise on this issue, and mirror legislation is expected to be enacted shortly by the U.S. Congress. (This apparently is one of those instances anticipated by Professor Wonnacott where for political principle Canada is prepared to face the cost of retaliation.)

Compulsory licensing of pharmaceutical patents

Section 41 of the Canadian Patent Law provides that any company may request the Canadian Commissioner of Patents to provide a compulsory license for pharmaceutical patents, and that only a nominal royalty of four per cent is paid. While the legislation was intended to address assertions that foreign pharmaceutical companies were making inordinately high profits, its effect has been to allow companies that have not contributed to the costly and risky research and development process to invade the market of the innovator, reducing his return and his incentive to invest in new product research and development. This past summer, it appeared that this dispute was about to be resolved when Andre Ouellet, then-Minister of Consumer and Corporate Affairs, announced the Canadian Government's decision to introduce modifying legislation in the fall. Unfortunately, the new Minister, Judy Erola, does not appear to share her predecessor's inclination to modify Section 41.

Postal rates

Canada has had regulations providing for second-class classification differentials on nonCanadian publications since 1969. It was not until 1 April 1979, however, that a discriminatory rate system was enacted. Under the system the lowest second-class rate is afforded to Canadian publications (magazines and newspapers). A somewhat higher rate is applied to nonCanadian publications printed and mailed in Canada (e.g., Time Magazine). The highest rate, which was considerably higher than the other two, is applied to nonCanadian publications printed outside of Canada, trucked into Canada in bulk, and mailed to Canadian subscribers, newsdealers, etc.

The rationale for these differentiated and discriminatory rates has always been to provide support to Canadian publications and to Canadian cultural policy, which seeks to foster 'Canadianness' and shield Canadians against the influence of foreign, particularly U.S., culture.

A number of bilateral discussions on this matter have been held over the years. Formal GATT Article XXII consultations were held in Geneva late last year, to no avail.

On July 14 Canadian Communications Minister Francis Fox announced that preferential postage rates for second-class publications in Canada will begin to be phased out. The result of this action will be an increase in already discriminatory postal rates on U.S. magazines and periodicals printed and mailed in bulk in Canada, and the U.S. publications printed in the United States, trucked to Canada, and mailed in Canada.

Extension of Canada's customs territory

This past summer, Canada extended its customs territory from 12 to 200 miles. The purpose of this policy was purely protectionist – an attempt to increase benefits for Canadian manufacturers from offshore drilling. With the extension, all supplies, equipment, and the drilling rigs themselves became dutiable. While the change in Canadian practice technically conforms to current U.S. practice, in reality only those drilling rigs actually attached to the ocean floor are subject to duty in U.S. territorial waters. The great majority of the drilling rigs in U.S. waters are floating rigs and therefore not subject to duty.

Protectionism on both sides of the border

These are but a few examples of the protectionist policies being pursued in Ottawa. Some of you here today can correctly point to protectionist measures being maintained south of the border, such as a number of 'Buy America' restrictions under various U.S. laws. There is, however, a subtle, yet important, difference. The current administration in Washington is committed to pursuing free trade policies, but is faced with a legislature which does not generally share those views. A myriad of protectionist legislation is introduced in the U.S. Congress each year, which is strenuously opposed by the Reagan administration. At times, despite Administration efforts, some protectionist legislation, such as 'Buy America' restrictions, is enacted. At other times, the Administration takes temporary measures against imports, such as import quotas on specialty steel, in order to forestall more drastic action by the Congress.

In Ottawa, protectionist measures originate in the government, not the Parliament. Many of the trade irritants affecting the Canada/U.S. economic relationship today could be avoided if the Government in Ottawa undertook the same efforts to oppose protectionist measures as does the Reagan administration in its dealings with Congress.

A perfect example of the divergent approaches of the two governments on this issue is the current debate over domestic content requirements. In the United States, a major effort has been underway for over a year in the U.S. Congress to enact domestic content requirements on automobiles. The Reagan administration has been publicly and actively opposing this effort and is spending considerable political capital in this endeavour. A similar proposal was made last summer in Canada by a federally appointed private-sector task force. Instead of unequivocal opposition to this concept as voiced by the Reagan administration, the Canadian government has failed to take a strong stand on the issue, leading many to fear that Ottawa may succumb to the protectionists.

Canada/U.S. free trade

While there has been a great deal of attention given lately to the concept of a free-trade arrangement between the United States and Canada, the Canadian government has decided that such an approach is perhaps too ambitious at this time. Instead, they are examining the concept of limited sectoral free-trade arrangements similar to the Auto Pact. Ambassador Brock has indicated that the United States would be willing to discuss such an approach if the Canadian government decides to pursue it.

While sectoral free trade falls short of the broader approach advocated by Professor Wonnacott, it could be a significant step in the right direction. Of course, a number of basic conceptual questions will need to be answered first. Will these sectoral agreements only address tariffs, or all barriers to trade? Would such sectoral arrangements be consistent with the GATT? How will foreign investment be dealt with under the Canadian proposal? How will states/provinces be dealt with? In addition, the sectors currently under examination in Ottawa appear to be geared to Canadian interests. For such an approach to gain necessary support in the United States, other sectors of interest to U.S. industry may also have to be addressed.

Despite these obstacles, the Canadian initiative is well worth exploring. Whether or not any agreements are ever reached, it marks an important step by Ottawa in the direction of trade liberalization. If the Trudeau government, or its successor for that matter, truly desires a reduction of trade barriers on *both* sides or the border, then perhaps the incidence of trade irritants between our two great nations can be reduced, if not eliminated. If such a commitment is not forthcoming from Ottawa, then I am afraid that Professor Wonnacott's concerns over U.S. reciprocity aimed at Canada may become a reality.

Canada/U.S. trade policy issues: do we need a new institution?

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The purpose of this brief note is to examine the proposition that some of the disputes, problems, issues and differences of policy as between Canada and the United States in trade and economic relations could more easily be resolved if there was some new consultative, or adjudicative, or arbitral institution with authority to address such matters. The question of whether there ought to be some sort of joint body, possibly a revival of the Joint Cabinet Committee on Trade and Economic Affairs or some new, mixed body of governmental representatives and members of the business community as examined at intervals, in Ottawa, and, I would assume, in Washington. There are a number of private sector cross-border bodies; the participants in the more cordial of the encounters of these groups must ask themselves whether the habit of friendly dispute and exchanges of views with which they are familiar could not be extended in some organized, structured manner so that random disputes between the two national governments are more intelligently managed.

Donald Macdonald, who, as a Minister, certainly had some experience of discussing issues with U.S. cabinet officers, has argued that there is a range of trade policy disputes that could perhaps be dealt with, as between Canada and the U.S., by some new body with authority to find the facts and propose solutions; it would be a mechanism of conciliation, not an arbitral or adjudicative body (see Macdonald 1982). In this note I question whether it is likely that we can solve or more easily deal with our Canada/U.S. trade policy and economic policy issues by putting any new institution in place.

Asking this question leads to inquiry in two directions: first, why do so many disputes arise as between Canada and the U.S. in relation to our two national trade policies and our two economic policies; and second, what institutions are now in place in this area, or in other related areas, and does the way they function suggest we could gain by adding yet another institution with some dispute-resolving mandate.

It is usual to argue that the reason there are, at any given moment, a number of disputes between Canada and the U.S. in regard to trade and general economic policies is because there is such a volume of trade and such a complex web of economic relationships between the two countries that differences of view and frictions are bound to arise. And, this explanation concludes, given that Canada and the U.S. are two different countries, there are bound to be differences, in these and other areas, of national interests. Hence the differences of opinion, hence the nagging disputes. This perspective, which reeks of Canadian common sense, was frequently expounded by Mr. Pearson. In my view, relying on this partial truth encourages an unhelpful complacency. The first component of the view is just a truism; clearly, if we had no trade and economic relations with the U.S. there would be little scope for dispute; however, this glimpse of the obvious does not get us very far. The second component, that there are differences of national interests, is too easy an assumption, and is therefore, likely to be misleading.

My view, based on some twenty-five years of participation in the process of Canada/U.S. economic relations, and on some, perhaps rather unorganized and unscholarly, reflection and study, is that the supposed differences in national interests are, in regard to a great many issues, just that – supposed, perceived, but not real in more than the superficial and short term. Canada and the U.S. are each other's best customers; their economies are meshed in a more detailed and extensive manner than the economies of any two other nations. Canada, as John Dafoe had to remind an earlier generation, is an 'American nation' and it is unlikely, in the nature of that fact, that in the longer term, U.S. national interests and Canadian national interests will be so different as to be irreconcilable. Many *perceived* differences are no more than failures to think through carefully what is the U.S. interest and what is the Canadian interest. And in both countries the political process yields a short-term premium for politicians who may choose to capitalize on supposed differences. In the U.S. a politician can usually secure some attention by complaining about the laxness of the Administration in dealing with some other country, and there is often something to be gained from taking up the special pleading of some interest group that has a complaint against Canada. Canadians hold that the U.S. congressional system and the separation of powers tends to institutionalize, even to magnify, the pressure of special interests. This may be so, but in Canada special interests are also adept at special pleading, and there has never been a time when in Ottawa one could not find some politicians eager to take the field against supposed U.S. pressures on Canada. I would not go so far as to say that there could never be a real, bedrock, quite unreconcilable difference of national interests in the economic policy area as between the two countries, but I find it difficult to think of one. The Canada/U.S. issues which spring to mind prove to be issues in which there is a *perceived* difference of interests but not any real difference when the issue is closely examined. Let us consider some recent trade and economic issues in a moment.

There is one assumption underlying the general view set out above: that is, that it is in the interest of the U.S., given that the Canadian confederation exists, that it should continue to exist, and therefore that it should be politically and economically viable. It is not in the U.S. interest that Canada should get relatively poorer or less viable. This is a simple proposition of which many American politicians, journalists and administrators seem often to be unaware, and there is the problem.

Related to, or perhaps an aspect of, the frequent failure to think out what is the real national interest, and to question whether an alleged difference of interests is real, is the habit of considering the conduct of Canada/U.S. relations as necessarily yielding a series of gains or losses, of being, to use the jargon, a zero-sum game. If one fails to examine an issue carefully, and so imagines a difference of interest where there is none, it is easy to adopt the view that its solution must involve one interest and not the other being served. It seems to me to be a ridiculously obvious that many, if not most, transactions and relationships between countries or between individuals are mutually advantageous, that both sides gain. Why then should anyone think of Canada/U.S. relations as involving one side or the other winning, the other or the one losing, as though the analog was the relationship between a used-car salesman and a customer he is unlikely to deal with again.

Some years ago a Mr. Joseph Nye, who was, I was given to understand, an expert from Harvard, called on me to interview me for a study of Canada/U.S. relations. He had with him a long list of issues in the trade and economic areas which had been raised in such bodies as the old Joint Cabinet Committee, and he wanted my opinion as to whether, on each of these issues, Canada had won or lost. I do not recall that, for any of these issues there was any real difference between the interest of the U.S. and the interest of Canada, and I thought that for many of the issues, it was evident that either both countries had been disadvantaged by the failure to solve an issue, or by its solution on terms which one or other party felt was unreasonable, or that, for other issues, both countries had obviously gained by the process of identifying interests more fundamental than those of the interest groups involved, and then devising mutually advantageous solutions. Mr. Nye seemed to get rather exasperated with me because I kept insisting that he was asking either the wrong question, or, at best, an uninteresting question, and because I kept insisting on speaking to a different question.

One reason why Canada/U.S. relations should not be approximated to that between a used-car salesman and his one-time customer is that the relationship between the two countries is a continuing one. If one country acts to its short term gain to the disadvantage of the other, if the U.S. uses its overwhelming power and its multiplicity of bargaining counters to impose an unwelcome solution on Canada, the U.S. will pay a price in terms of suspicion and resentment that will affect other future matters. If Canada tries to outsmart, outmanœuvre the U.S., perhaps by getting together a temporary anti-American alliance in some international meeting, there will be a price to be paid in terms of the impact on U.S. conduct in the future. Of course there are many occasions, far too many, when U.S. and Canadian representatives have had to defend opposed positions; it is my experience that this arises because one side or the other, often both, have not thought through the issues and/or have failed to communicate their view to the other. I have been involved in a number of Canadian disputes with the U.S., and I cannot recall that any of these involved anything more than attempts by one country to force mistaken policies and mistaken perceptions on the other. Fairly frequently, the representatives of both countries knew this to be the case. The fact is that relations between Canada and the U.S., as between other countries, is a *process* – ideally, a process of constant adjustment and accommodation, but, too frequently, a comedy of political error and misconception.

Let's look at some recent issues in this light. The episode involving the application by the U.S. of the so-called Equalization Tax, and the proposition that borrowing by Canada should be exempt, was a case in which U.S. policymakers initially failed to perceive that they could not advance U.S. interests by imposing a burden on Canada, which would raise costs in Canada and would disrupt Canadian financial markets (Plumptre 1977, 204-11). This was merely a case of U.S. policymakers failing to assess the U.S. interest correctly. Again, at the time of the 'Nixon shock' in 1971, there were many Americans, apparently even the Secretary of the Treasury, who seemed to be under the illusion that if the U.S. imposed a barrier to the exports of its best customer, the U.S. would somehow have improved its position. This perception that the U.S. can better itself by impoverishing Canada very frequently features in discussions in Washington; it is part of the essentially adversarial way so many Americans see their existence, including foreign policy. Aside from the fact that it is dubious economic reasoning, it is at variance with my assumption that it is not in the U.S. interest to weaken Canada; it is consistent, unfortunately, with thinking of issues in the we-win/you-lose, zero-sum fashion.

If we take a different issue, say the so-called 'border-broadcasting' issue, we can ask the same sort of question about the real U.S. interest. Is there really some fundamental national interest in licensing radio broadcasting firms in the U.S. to solicit advertising from Canadian firms? Given that broadcasting is a heavily regulated industry, in both countries, is it not reasonable to ask: Why was this issue allowed to arise in the first place? Why were these stations licensed by the U.S. authorities? Is there anything more here than the fortunes of a few private investors? It is hard to believe otherwise. Similarly, we might ask why the U.S. acted as though some vital national interest was affected when Canada moved against the 'Canadian' editions of certain U.S. magazines. Was there any danger that U.S. culture, U.S. perceptions, would be less well known in Canada because of the Canadian action? Given the massive circulation in Canada of the U.S. editions of U.S. periodicals, and given the effectiveness of the U.S. book publishing industry, there was no threat to continued Canadian awareness of the U.S. fact. Was there really anything more here than special interest? We could, of course, ask the related questions about Canadian action in this sector. Are Canadians somehow more worthy, more informed, more virtuous, more Canadian because some revenue, we assume, was diverted to *Macleans*? I doubt the answer would be unanimous.

There is a range of issues between Canada and the U.S. involving the proper role and status of the private corporation. In regard to a number of these issues the U.S. appears to act on the view that the subsidiaries abroad of U.S. parent firms may properly and legally be brought within the jurisdiction of U.S. law, and can quite correctly be used as a conduit by which U.S. policy may be imposed on other countries. This is the current issue of 'extraterritoriality', as manifested in regard to securities regulation, banking (i.e. the Iran assets issue), controls on the re-export of U.S. goods and goods based on U.S. origin technology (the Export Administration Act of 1979) and antitrust legislation. No other country seems to have gone as far as the United States in asserting a jurisdiction in these matters outside the national territory, and no country so uses the subsidiaries of domestic corporations as vehicles for its foreign policy. Here U.S. policy is quite at variance with what is said to be the U.S. view as to the role in economic development, in the creation and distribution of wealth, of the private corporation. In accordance with that view the U.S. urges that Canada should accord the Canadian subsidiaries of U.S. corporations treatment no less favourable than the treatment given in Canada to Canadian-owned corporations – so-called 'national treatment'.[1] It is a characteristic of the failure to work out just what is the national interest that contradictory perceptions come to be followed in different areas. Clearly the U.S. cannot ask for 'national treatment' of subsidiaries if it is plain that, in the U.S. view, the foreign subsidiaries of U.S. parent firms are different from other firms in that foreign jurisdiction, that is, that they are subject, not only to the law of the host country, but also to U.S. law.

There are, of course, real problems, which many Canadians have perceived, as to how corporations, particularly subsidiaries of foreign parent firms, should conduct themselves in this economy. There is a pull of influence and method by the larger market and the stronger economy, manifested in procurement habits, in export allocation practices, in the allocation of research and development activities, and in the location of downstream processing facilities. The negative effects are not transmitted solely by U.S. controlled corporations but are also manifested through the conduct of Canadian based multinationals. If that is so, then the solutions will lie in the working out of standards or rules that apply to all corporations operating in Canada (say, in regard to procurement) and not merely to proposed new entrants from abroad. A policy of nondiscrimination in this area will be less objectionable to the U.S., more consistent with our views as to how Canadian controlled corporations should be treated in other countries, and perhaps more effective. It seems to me that we can serve Canadian interests without having a negative effect on U.S. national interests, although, of course, we might be disliked by some heads of some corporations, both U.S. and Canadian.

It may be questioned from these examples that it is my view that, on balance, Canada is more sinned against than sinning, in the area of trade and economic relations with the U.S. I think that is the case, and for a simple reason. Canadian actions which annoy and irritate the U.S. are often, perhaps nearly always, directed at the U.S. or designed to counter some U.S. action or pressure or policy. Often it is motivated by little more, by way of policy, than anti-Americanism which is so fashionable on the left everywhere and on the right not infrequently. Some of the U.S. exasperation with us, from time to time, is because some Americans understand that these may be our motives. By contrast, U.S. actions which annoy, irritate, many Canadians are often directed at third countries, at issues in which Canada is not part of the problem. Not infrequently, ill-thought-out U.S. action fails to achieve its purpose, but damages Canada, and it is the case that the U.S. representatives are sometimes not quick to see that they have designed a given measure foolishly, that is, without taking account of the range of U.S. interests. A case in point is the DISC issue; a measure designed to offset the subsidy practices of other countries has had, I suggest, its main impact in affecting decisions on plant location within North America.

I have argued above that Canada/U.S. issues in the trade and economic area are frequently the result of failure in one country or another to think out what is the national interest, and that this is compounded by the tendency to think of the conduct of relations between nation states as a zero-sum game. The question to be addressed is: Do we need, could we make good use of, some new consultative, adjudicatory or arbitral institution to resolve such issues? It seems fair to insist that the onus is on those who argue for a new institution to make a convincing case; we sceptics should not be required to prove a negative. I would go further and argue, by analogy, a sort of Occam's Razor approach: we should avoid creating new institutions unless there is a convincing case for them.

It would be helpful, at this point, to look at the various institutions, or models, and to note some history, relevant to existing institutions and proposed new institutions, in this policy area.

Economic policy in general is political policy, and trade policy, which deals, often enough, with micro issues, is so politicized and particularized, that it is a matter of fine judgement, case by case, as to whether it is preferable to seek cover by referring an issue between our two countries to some extra-political body (e.g., a GATT panel) or to keep it in the political realm, to be negotiated away. However, it is of some interest that in drafting the Havana Charter, the U.S., with support from Canada, pressed for a role in resolving trade policy disputes (i.e., disputes as to the meaning of the Charter provisions) for the International Court of Justice. This was strongly opposed by France. This Charter provision (Article 96) provided that the organization or its signatories could refer issues of interpretation to the Court; however, the Havana Charter was not given effect and this particular provision was not carried into the GATT. To this date it has remained the view of the trade policy community that trade policy issues are really too political to be passed to the ICJ. That may not remain the view indefinitely; in part developments in this direction will be affected by changes in the role and manner of working of the court itself.[2]

Turning now to consider the various institutions or established arrangements for addressing Canada/U.S. trade policy and economic policy issues and recent proposals for new institutions, we see that there is a broad range of models and proposals.

Multilateral fora

Many experienced federal officials have a clear preference for addressing issues with the U.S. within the terms of the relevant multilateral agreements. This has two separate but related aspects. First, it is possible to discuss bilaterally, informally or formally, at various levels, some particular issue in terms of the rules of the agreement. Thus the issue of the alleged procurement requirements negotiated by the Foreign Investment Review Agency (FIRA) with U.S. firms proposing new direct investment in Canada could be addressed bilaterally in terms of the rights and obligations of GATT Article III (National Treatment). Conceivably, such an issue could be examined bilaterally in this fashion for a considerable period; during the course of the discussion one or other or both parties might decide that it would be useful to involve the institutional arrangements of the multilateral agreement. This is a second technique. In the FIRA dispute, the U.S. decided, after what was virtually a Canadian invitation, to invoke the GATT dispute settlement mechanisms. This brings into play a judgement by representatives of the international community. If we made a list of Canada/U.S. issues in the trade policy area that have arisen in, say, the last twenty years, it would be clear that a broad range of issues have been resolved by close study of the GATT rules, but that only a small proportion have had to be taken to the multilateral forum. However, the fact that the multilateral institution is available has an impact on how and how quickly issues are resolved. It seems to me that the record would show that there is no demonstrated need, that is, the case has not been made, for an institutional arrangement which would displace or complicate the existing arrangements for the resolution of the broad range of issues covered by the General Agreement which does, in fact, over most issues with regard to traded goods. I would guess the same logic applies to the subject area of other institutions such as the IMF, the IBRD, etc. The fact is that the multilateral institutions do work well enough over a range of issues as between Canada and the U.S. and that there is no reason to not continue to rely on them.

Specialized bilateral institutions

Another important model, which anyone who thinks that Canada/U.S. issues in the trade field could, ideally, be better managed, is bound to consider, is the International Joint Commission. The experience of this joint institution, I understand, tends to show that a narrow range of detailed, specific issues can be assigned to such a body, particularly if there is prior argument that these issues are unlikely to be highly politicized. At the same time, there is a measure of insurance against issues becoming political if they can be assigned to such a specialized body, given that it has expertise and prestige. However, if the process fails, and an issue nominally within the purview of such a body becomes unmanageably political, then the standing of the institution can be damaged. It seems to me that if there was no GATT, and no multilateral dispute settlement mechanism, then there would be a case for a joint commission to deal with such trade policy issues as would arise from the working of the bilateral trade agreement. However, given the GATT apparatus, this basis for a trade-policy ICJ sort of body does not exist. A contrary view has been advanced by Donald Macdonald; in the article cited above he argues that we should draw on our experience with the ICJ in creating a Canada/U.S. Trade Commission.

High-level consultative mechanisms

At the opposite pole from a ICJ type of institution is an arrangement for consultation at the Ministerial level on some regular basis. Donald Macdonald sums up our experience succinctly:

> when an institution has been established between the two governments to deal with matters of high policy, such as ministerial committees to resolve economic problems, it has not worked. Ministers . . . need more manœuvrability than a bilateral committee can provide.

This is a comment on the Joint Cabinet Committee on Trade and Economic Affairs. Mr. Macdonald's judgement is concurred in by the Canadian-American Committee (Canadian-American Committee 1981, 11). The problems with such an organized, institutionalized device is that while it is sometimes useful for Cabinet officers to meet their opposite numbers from the other country, such occasions really cannot be planned for and held at regular intervals. If a meeting of such a Joint Cabinet Committee is scheduled many issues which could easily be settled bilaterally and advantageously at a lower level are kicked upstairs and politicized. Moreover, issues not ripe for resolution get put on the agenda. The result is often to sharpen differences, to encourage an adversarial approach, and to politicize many issues which involve essentially technical rather than policy considerations. Clearly we do not need to repeat this experiment.

Recent proposals

Against this background we can consider two recent proposals. The first is Mr. Donald Macdonald's proposal for a Joint Trade Commission, to help resolve a range of trade policy issues essentially by conciliation and factfinding. I do not think that in Mr. Macdonald's article he fully developed his idea; in particular he did not make clear why in his view such a body would be preferable, in the working of the various GATT codes, to the GATT machinery. Nor did he make clear just what would be the relationship, in legal terms, between a solution proposed by his joint body, and a formal finding of some such national body as the U.S. Court of International Trade or Canada's proposed Import Tribunal. This is important because private parties can and do pursue their cases through the national system; Mr. Macdonald has suggested that they should also be able to go to this new Trade Commission. There is, it seems to me, a case for keeping the state out of the business of participating as a principal in the resolution of essentially private disputes: for example, there may be something to be said for treating dumping not as an issue in which investigation and action by the state is required, but as a matter to be dealt with as between the parties, like a question of patent infringement. It may be too, that we should try to widen the area of arbitral procedure, using the established institutions of arbitration, to deal with some of such trade issues. In such a more radical reassessment of the administration of trade policy issues, there would then be a better case for looking at Macdonald's proposed Trade Commission. The second proposal is that advanced by the Canadian-American Committee (in the paper cited). 'We suggest that each government designate at some appropriate location within its structure a focal point to facilitate its management of bilateral economic issues, permanently staffed with a small nucleus of experienced persons.' The difficulty of this proposal is that in their brief pamphlet the Committee did not make a clear case why a 'focal point' is what is required; it seems to me that the Committee should set out the case in more detail. If they do they will see that there is one major problem: If in Canada and the U.S. we have the intelligence and the will to manage our affairs, then a 'focal point' is not essential. The issues will be focused on where and when necessary. On the other hand, if we fail to apply will and intelligence, a 'focal point' may be at best irrelevant, and at worse harmful, in that it may give great power to ill-informed officials with little understanding. We do not want them to have a 'focal point'. Reading and rereading the Committee's proposal, I came inevitably back to the notion that it is perception, will, understanding that is required, and given that there is a range of institutions and government agencies in place, these are the only new ingredients that are required; indeed, the most compelling part of the Committee's publication is Donald Macdonald's footnote on the sorry record of the U.S. judicial system in addressing issues with a Canada/U.S.content (Canadian-American Committee 1981, 11).

NOTES

1 See Rodney de C. Grey (1983) 'Extraterritoriality and Export Controls: A Canadian View', Tri-lateral Conference, Los Angeles, 20 September, 1983. mimeo. For a recent and comprehensive argument giving some support to the U.S. view on jurisdiction over subsidiaries, see: Robert B. Thompson (1983) 'United States jurisdiction over foreign subsidiaries: corporate and international law aspects', 15 *Law and Policy in International Business*, No. 2, 1983, 319-400

2 For a discussion of how the role of the ICJ is being enlarged, see Robert H. Brauer (1983) 'International conflict resolution: the ICJ chambers and the Gulf of Maine dispute' 23 *Virginia Journal of International Law*, 3, 1983, 463-86

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Institutional arrangements for managing the Canada/U.S. economic relationship

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INTRODUCTION

The Canada/U.S. economic relationship has become in the past year or so a subject of intense public interest in Canada. Proposals for a strengthened, perhaps more institutionalized, bilateral arrangement are coming from an increasing number of sectors of Canadian society, and these have been met by expressions of understanding and some interest from the U.S. side. Several private sector groups have entered into this discussion, often in response to some change in national policies as much as in anticipation of them. And provinces and states have become important factors over the past decade or so as the volume of regional cross-border trade has increased much faster than that of trade within the two nations. There is a danger, however, that too much momentum will be built up too quickly without due attention being paid to each suggestion or idea put forward.

Tensions in the relationship and proposals for further trade liberalization have brought into question the adequacy of the institutional arrangements for managing bilateral issues in trade and economic areas, giving rise to calls for the creation of institutions or the improvement of existing ones. Rarely, however, has a persuasive case for institutional reform been made either in the academic literature or in proposals elsewhere. The possible functions of any new or revamped institutional arrangements – consultation, dispute settlement, research – have been left vague; and there has been little analysis of the multilateral implications of proposed new bilateral arrangements.

This paper makes the case that the management systems in place covering the Canada/U.S. economic relationship are basically sound, but that they might be strengthened in certain respects. Their evolution over time, and the important province/state and private sector involvement in particular, are reviewed. As well, existing arrangements are evaluated in terms of problems and issues both inherent in the relationship and arising from particular policies and practices on both sides. In this latter context, a case is developed for some changes in the way the bilateral economic relationship is managed.

An asymmetric relationship

It is a truism to state that differences between Canada and the United States on economic issues are both frequent and numerous because of the large volume of bilateral trade, the complexity of economic linkages, and the close interdependence of the two countries. It is not so obvious, however, how these frictions can be managed given the widely disparate sizes of the two economies.

Canada is generally a regional economic concern of U.S. policymakers; the U.S. is the foremost foreign economic policy concern of Canadians. Thus most Canadian economic policies, domestic or international, anticipate or are in response to U.S. actions, and these actions can have adverse effects on particular U.S. firms or industries. On the other hand, U.S. economic policies, which are often directed at third countries, can have profound effects on the overall well-being of the Canadian economy. Thus, actions by either country can adversely affect the other, but given the asymmetrical nature of the relationship, the impact on Canada is generally far greater.

How to manage well the economic relationship in this highly imbalanced context has always been a challenge, particularly to the junior partner. As the world economy evolves rapidly and as the relationship between Canada and the United States becomes ever closer, more complex, and more important, the challenge of bilateral management is becoming even greater.

ELEMENTS OF AN EFFECTIVE MANAGEMENT SYSTEM

An effective management system includes the necessary institutions, rules, and procedures which govern the economic and trade policies of the two countries. To a large extent, these instruments of policy have been provided by the postwar multilateral arrangements such as the GATT, which both countries have played a leading role in creating and maintaining. But there exists also a wide variety of special bilateral arrangements that have been put into place to deal with uniquely bilateral issues and problems, as well as to carry out the routine business of the two countries with each other.

A strong case can be made that the elements of the existing management system should not be tampered with if they are working well and performing the necessary functions. Institutional arrangements should, however, be sufficiently flexible to respond to changing needs and issues. Some might be allowed to lapse when they are no longer needed; others might be renewed when needed again. New institutional arrangements should not be invented for their own sake, but rather only to fill recognized gaps and to meet recognized needs.

Arrangements for managing economic and trade relations cannot be viewed in isolation from arrangements to manage other sectors of Canada/U.S. relations, such as in the defence or environmental areas. And the principles on which arrangements in the economic area are based must be consistent with those governing the management of relations in other areas.

An effective system for managing bilateral economic relations should have as its broad goals, firstly, the opening up of opportunities for co-operative action that will bring benefits to both countries through trade and other economic activities, and secondly, the resolving of bilateral issues and problems in ways that are fair to both sides and that add to the mutual interests of both countries.

MANAGEMENT IN THE PREWAR PERIOD

In looking at today's and tomorrow's needs for an effective system of managing economic and trade relations, it is instructive to look back. On the trade side, in the prewar period, the main policy instruments of both countries were their customs tariff systems, bolstered by such supplementary devices as antidumping duties and complex arrangements for administering the customs system. In contrast, the present trade policy systems of both countries contain a far greater array of nontariff, often contingent, measures of one kind or another that can be used to obstruct or distort all international, including bilateral, trade.

Until the mid-1930s, both countries maintained extremely high protective tariffs on bilateral trade, especially in the area of manufactures and most agricultural products.[1] The reversal of U.S. trade policies in the early 1930s under the administration of Franklin Roosevelt provided a new basis for Canada-U.S. trade relations. Following the adoption in 1934 of the U.S. Reciprocal Trade Agreements Act, Canada was quick to respond to the U.S. invitation to reduce barriers to cross-border trade. The bilateral trade agreements of 1935 and 1938 began a process of liberalization of cross-border trade, and the adoption of rules governing this trade, which has continued until the present time.

POSTWAR MULTILATERAL ECONOMIC MANAGEMENT

In contrast to the prewar period, a complex array of institutional arrangements for managing Canada/U.S. economic and trade relations has come into place, not only on a bilateral basis but also within the multilateral economic system to which the two countries belong. Since the Second World War, an important part of the management of Canada/U.S. economic relations has taken place within the framework of multilateral systems, notably the GATT, the IMF, and the OECD. In the more recent period, the facilities offered by these multilateral institutions have been supplemented, in certain respects, by the periodic 'quadrilateral' meetings of the trade ministers of the United States, the European Community, Japan, and Canada, and the annual summit meetings of the seven leading industrial powers.

With respect to trade, the Canada/U.S. agreements concluded in the later 1930s were in effect replaced by the GATT when it was adopted by the two countries in 1947. Since then the GATT has served effectively as the main trade agreement between the two countries, providing the framework for the reduction of tariffs and other barriers to cross-border trade, and embodying a set of rules governing bilateral trade. GATT has also provided facilities for ongoing consultations on trade matters between Canada and the United States, as have the other multilateral arrangements referred to earlier. The GATT

Secretariat carries on a program of independent research and analysis of developments in world trade and the policies of the main trading countries. Some of this work is directly relevant to Canada/U.S. bilateral trade and other economic issues. GATT provides facilities and procedures for the resolution of disputes over trade issues, which have been used on a number of occasions by both Canada and the United States to help resolve bilateral trade disputes. Finally, GATT serves the important function of providing a set of rights and obligations enjoyed by Canada and the U.S. in their bilateral trade relationship, and a number of underlying principles governing this relationship.

In other economic areas, apart from trade, multilateral arrangements also serve as the framework for dealing with bilateral issues. In the OECD, for example, a continuing process of analysis and consultation goes on with respect to an entire range of economic policies of the member countries. Obviously, such a process contributes to a better understanding between Canada and the United States of each other's policies, and provides additional opportunities for each country to pressure on the other to avoid measures which can damage its interests. This process of consultation has been reinforced by the annual summit meetings, which provide additional opportunities at the level of heads of government for Canada and the United States to consult each other on important economic developments and issues, and to attempt to influence the formulation and operation of each other's policies.

In the area of monetary policy, the International Monetary Fund and the Bank of International Settlements also provide a multilateral framework for continuing consultation between Canada and the United States on developments and issues that can have a direct bearing on bilateral relationships. Both countries manage their domestic economic policies, and periodically their exchange rates, within the broader multilateral system. The facilities for co-ordinating Canadian and U.S. policies in this area that are provided by the IMF and the BIS are as useful as ever, and perhaps even more so, in the absence of the IMF rules for fixed exchange rates that were abandoned in the early 1970s.

Similarly, the World Bank serves as a framework for co-ordinating the development assistance policies of the two countries within a broader global system. The facilities provided by the World Bank for research and analysis of development needs and programs in the developing world serve to increase the effectiveness of both countries' bilateral programs, and have provided a basis for a number of co-operative projects that have been co-ordinated by the Bank and assisted by its own resources. The several regional development banks to which the two countries belong serve similar functions in Asia, Latin American, the Caribbean, and Africa.

The evolution of the particular bilateral economic relationship between Canada and the United States should not, indeed cannot, disregard the role and functions of these multilateral arrangements which have served the two countries well in their bilateral relationships, as well as in the broader global context. The maintenance and strengthening of these multilateral arrangements may in one sense be more important to Canada, as the junior partner, than to the United States. Within the multilateral system, Canada's influence can be joined with others to bear more effectively on the formulation and operation of U.S. policies than would be possible on a one-to-one bilateral basis. In part for this reason, successive Canadian governments have stressed Canada's support for the GATT and other multilateral arrangements. At the same time, the United States, as the world's leading economic power, has a special stake in the maintenance of effective multilateral arrangements in trade and economic areas. The United States has played a determining role in their creation and operation. Government leaders in Washington have restated their interest in the preservation and strengthening of these systems.

It would thus be in the interest of neither country, and contrary to their stated policies, to pursue bilateral arrangements for managing economic and trade relations that would weaken these multilateral systems. But it should be possible to design bilateral arrangements which would build on the multilateral systems to deal with issues of uniquely bilateral interest.

BILATERAL MANAGEMENT

The federal governments of Canada and the United States are primarily responsible for managing their bilateral trade and economic relations as set out in international law and their respective constitutions. A variety of channels and contacts have been created at the federal level for conducting relations between the two countries.

In addition, provincial and state governments and private sector groups have major interests in the bilateral trade and economic relationship and therefore are also involved in the process of managing bilateral relations.

Federal

The embassies and consulates of both countries are the principal channels of communication and the main instruments for the conduct of regular business as each country pursues the interests of its own country in the other's capital. Canada's embassy in Washington is the largest and most important of Canada's diplomatic missions anywhere. The U.S. embassy in Ottawa, while smaller in size, is the largest in Ottawa. Traditionally both countries have practised 'quiet diplomacy' as recommended by the Merchant-Heeney Report of 1965.[2] Recently, however, the Canadian embassy has been more aggressively developing relationships on Capitol Hill and carrying Canadian interests directly to members of Congress, partly in response to the shift in power away from the U.S. Executive Branch towards Congress in the area of trade and economic policy.[3]

Within the executive branch of both federal governments, there are a number of departments with interests in Canada/U.S. economic and trade relations. But the principal responsibilities for bilateral relations are carried by the Department of External Affairs in Canada and the State Department in the United States. As part of the Canadian government's plans to give increased priority to trade objectives, the federal bureaucracy in early 1982 underwent a major reorganization, with the trade responsibilities of the former Department of Industry, Trade and Commerce being incorporated into the Department of External Affairs. Within the new department, there is an assistant deputy minister of a United States Bureau, which has beneath it six separate divisions including the United States Trade and Economic Relations Division.[4] This reorganization demonstrates an increase in the priority given by the Canadian government to relations with the United States.

Understandably, the same level of high priority has not been accorded Canada within the State Department. However, on 1 September 1983, a new position, that of Deputy Assistant Secretary for Canada, came into effect, within a renamed Bureau of European and Canadian Affairs. This new position represents a renewed interest in, and higher priority for, relations with Canada.

The U.S. government also considered in 1982 and 1983 a proposal for major reorganization which would incorporate the economic and business elements of the present Department of Commerce with the Office of the United States Trade Representative to create a new Department of International Trade and Industry. In terms of Canadian interests, this would likely be a retrograde step should this or a related proposal emerge again. It would reduce the stature within the administration of the Trade Representative and remove his direct access to the President. Secondly, by combining the Office of the Trade Representative with the Department of Commerce, the new department could be more open to protectionist pressures from U.S. manufacturing and industrial sectors.

In addition to the above-mentioned departments, there are a number of others with an interest, to a greater or lesser degree, in trade relations between Canada and the United States. On the Canadian side, these include for example the Departments of Finance, Agriculture, Defence, Consumer and Corporate Affairs, and National Revenue; and on the U.S. side, the departments of Treasury, Agriculture, Defense, and Interior. There are frequent direct contacts between ministers and officials of these functional departments outside the regular channels established by the embassies or the Department of External Affairs and the State Department. These contacts serve to exchange information and resolve issues between the two countries as they arise. They can also give rise to serious problems of co-ordination.

Formal visits between the President of the United States and the Prime Minister of Canada also serve as an important forum for the exchange of views on broad areas of mutual concern to the two countries, both in a bilateral and a global context. These meetings establish personal relationships and have an important symbolic value. They are not meant, however, to settle specific disputes, although they may set the tone for a particular round of negotiations or help to break an impasse. In setting the tone of the bilateral relationship, the personal attributes and approaches of the heads of government are particularly important. It is generally acknowledged, for example, that one of the most favourable periods in Canada/U.S. relations was between 1935 and 1945, largely reflecting the close relationship between President Roosevelt and Prime Minister MacKenzie King. Conversely, bilateral relations can be seriously hampered when there are strained personal relations between the leaders of the two governments, as exemplified by the Kennedy-Diefenbaker relationship.

Meetings and other contacts between Canadian ministers and U.S. secretaries also establish personal relationships which serve to keep ministers informed and can provide a basis for dealing with some issues more effectively. Contacts are generally one-on-one; an example is the 1983 meeting between the Canadian Minister of Justice and the Attorney General of the United States to discuss the unitary tax system being applied by several states to multinational corporations. Such consultations serve to deal with issues on an ad hoc, rather than on a regular, basis. A noteworthy exception to this pattern has been the series of highly successful meetings between the Canadian Secretary of State for External Affairs and the U.S. Secretary of State begun in mid-1982. These regular meetings gave personal direction to the management of the bilateral relationship. However, because of the frequent turnover of ministers and secretaries, these special relationships cannot be relied upon in the ongoing management of bilateral economic relations.

In addition to the ad hoc meetings and contacts between officials and government leaders, there have been a number of efforts to establish joint committees of ministers and/or officials to manage general or specific aspects of the bilateral economic and trade relationships on an ongoing basis.

The Canada/U.S. Ministerial Committee on Trade and Economic Affairs was established in 1953 on Canada's initiative. It was hoped that this committee not only would improve the exchange of information and consultation between the two countries, but also would help reduce the imbalance in the Canada/U.S. relationship by providing Canadians with a direct means of influencing American trade and economic policy. The Committee consisted of a number of Canadian Ministers and U.S. Secretaries concerned with bilateral trade and economic affairs.[5] Each delegation also included some 15-25 civil servants, and occasionally special advisors such as the heads of the central banks. The meetings, which were held fairly regularly up until 1970, were initially designed to be informal discussions on issues which might adversely affect economic relations but which might then lead to proposals for measures to improve relations for the consideration of the two governments. However, no permanent secretariat was created, nor was there any attempt by the ministers to carry on work collectively on a year-round basis. Any unresolved problems were referred for further study to Canadian and U.S. officials or to joint working groups.

The Ministerial Committee on Trade and Economic Affairs was fairly successful at the outset as an informal mechanism for consultation, but it became increasingly formal and structured resulting in a decline in its effectiveness. The timing of committee meetings and the setting of agendas often meant that some issues became unnecessarily politicized while other important issues that arose between meetings were not dealt with at all by the committee. It also became difficult to assemble so many busy ministers and secretaries at one time. Finally, increasing press attention tended to focus on the failure of the Committee to arrive at concrete decisions and agreements, thereby exacerbating any disputes. This adverse publicity further prompted ministers and secretaries to abandon the Committee. While there appears to be little interest in its revitalization at present, the Committee could presumably be reactivated if circumstances warranted.

The Ministerial Committee established several working groups to consider specific, usually technical matters, which have had varying degrees of success. For example, the Canada/U.S. Balance of Payments Committee, comprised of officials from both countries, met between 1963 and 1968 to help clarify, and where possible modify, the trade and financial policies of the two countries for their mutual benefit. However, the Committee's efforts met with little success largely because members of the Committee were not of a sufficiently high level in their respective bureaucracies to have much influence on policy formulation, and because Canada preferred to deal with issues on an ad hoc basis.

The U.S./Canada Trade Statistics Committee, established in 1971 to reconcile, harmonize, and monitor counterpart Canada/U.S. trade statistics, has been considerably more successful. Creation of the committee was prompted by the persistently wide discrepancies between the trade statistics of the two countries which tended to exacerbate trade related disputes. These statistics are now reconciled on a quarterly basis, utilizing increasingly computerized techniques.

The two governments continue to establish, from time to time, joint committees to discuss specific matters of mutual concern. Recent examples are the Energy Consulting Mechanism, a bilateral group of officials set up to consult on a broad range of issues related to energy, and the Consultative Mechanism on Trucking, established as a result of the recent trucking dispute to exchange information on a full range of truck transportation problems.

There is also at the federal level another bilateral committee of a somewhat different type, the Canada/United States Interparliamentary Group. Since 1959, this group has held meetings at least annually to provide liaison between the legislatures of the two countries, and to promote mutual understanding in a general way. It serves as another form of response to the difficulties posed by the U.S. Congressional system of government by affording Canadian parliamentarians the opportunity to put forward directly Canada's position and interests to members of Congress.

Within the bilateral relationship, there is a historical precedent for joint bodies of a rather different order. These joint boards and commissions include several which are not directly related to trade and economics, notably the International Joint Commission, and those related to fisheries and to defence cooperation and procurement. They have served both countries well. They have tended to equalize an otherwise greatly unbalanced relationship; in some of them, particularly those which are technically oriented, Canada appears to have fared better than the U.S. by developing greater expertise and by being better prepared.

Thus, there already exists a variety of mechanisms at the federal level for the exchange of information, the resolution of disputes, and the management of the bilateral trade and economic relationship in general.[6] However, except for a very few ongoing joint committees, these mechanisms are ad hoc in nature which over recent years appears to have been the preferred method of dealing with issues between the two countries.

Provincial/state involvement

All of the provinces and most of the U.S. states have a substantial interest in the management and promotion of the Canada/U.S. economic relationship. Although the two federal governments have overriding responsibility for international trade, provincial and state governments also carry important responsibilities for economic development and regulatory measures – for example, government procurement policies and various tax and subsidy measures. These can have an obvious impact on bilateral trade and other economic relations.

The provinces have long sought a larger role in the formulation of Canada's trade policy, but not until the 1970s, when the Tokyo Round of multilateral trade negotiations was in progress in Geneva, was there a concerted effort to involve the provinces in the development of Canada's trade policy position. In 1975, a Canadian Tariffs and Trade Committee (CTTC) was established, followed in 1977 by the appointment of a Canadian Co-ordinator for Trade Negotiations (CCTN) to liaise with provincial governments and private sector organizations. The CCTN in particular initiated consultations quite vigorously. It is generally agreed that, as a result, the communications process and the role of the provinces were greatly improved. However, these were temporary arrangements, created to aid in the development of Canada's position during the Tokyo Round. Once the negotiations ended, so did both of these mechanisms.

In June 1982, the federal minister responsible for international trade initiated the first of a series of federal-provincial conferences on Canada's international trade policy. The ministers agreed to meet 'as appropriate' to review current trade issues and to seek ways of co-ordinating efforts in export promotion. Several meetings have been held to date, supplemented by more frequent meetings at the deputy and assistant deputy minister level. In addition, a number of the provinces at present are attempting to co-ordinate provincial positions on bilateral trade issues.[7]

On the U.S. side, an International Policy Advisory Committee on Trade, made up of federal, state, and local government representatives and chaired by the United States Trade Representative, was recently established. Although this committee could potentially provide a means for the states to provide input into federal trade policies, its primary purpose is to advise local and state authorities on what export development measures (and other measures) they can adopt in accordance with international trade rules and obligations. Some of the states have been vigorously pursuing export development policies – such as export subsidy programs, as well as 'Buy State' and 'Buy America' policies – which have come very close to conflicting with the international obligations of the United States. However, except in the area of export development, there is in general little formal or regular consultation with the states on international trade policy. In comparison with the Canadian situation, this reflects the less powerful constitutional role of the states in the U.S. federal system, and the greater representation of state interests in the federal legislature.

In addition to their input into bilateral trade and economic policy through the federal government, the provinces have had further impact by way of their direct links with U.S. state governments. These take a number of forms. First, there are the meetings between provincial and state government leaders and legislators for the discussion of issues of mutual concern, including trade and economic matters. The premier of Ontario, for example, meets regularly with the Great Lakes governors. Since 1973, annual conferences have been held between the New England governors and eastern Canadian premiers. At their June 1983 conference, a special committee was established to continue ongoing work towards broadening trade and economic relations between the Atlantic provinces, Quebec, and the northeastern United States. Similar, although less formalized, meetings are also held in the West.

Secondly, several provinces have set up offices in a number of state to promote trade and tourism and to encourage economic development.[8] Ontario and Quebec have the largest number; British Columbia, Alberta, and Nova Scotia have also set up offices in some of the larger U.S. cities. Similar offices have been established by several U.S. states, including Vermont, New York, and Georgia, in certain Canadian cities.[9] Some of these are staffed by economic counsellors and commercial attachés who can offer marketing and other advice to potential export companies in their home provinces or states. In addition, they explain to foreign companies the financial and tax assistance, as well as other advantages, of opening branch plants in Canada or the United States as the case may be.

Finally, there are frequent contacts between provincial and state officials, in part to draw up and implement the great many formal and informal arrangements between the states and provinces. These arrangements cover a wide range of areas including trade and economic matters such as transportation, natural resources, energy, commerce, and industry.

Because of provincial jurisdiction in a variety of economic areas, and particular provincial linkages with certain U.S. states, the Canadian provinces have not only an interest in Canada/U.S. trade, but also can have considerable impact upon the bilateral relationship. The importance of the provincial role is increasingly being recognized, most recently in the establishment of the above-noted federal-provincial trade conferences.

Private-sector involvement

Private-sector interests in the Canada/U.S. economic relationship are large and complex. In both Canada and the United States, representatives of the private sector are pressing for greater input into federal trade policy. Groups from various sectors of the economy – industry, small business, agriculture – have their own channels into policymaking processes in the federal governments, for example through government departments and Congressional and Parliamentary Committees. Concurrent with the Tokyo Round, the Canadian Trade and Tariffs Committee, and the Canadian Co-ordinator for Trade Negotiations provided the point of initial contact for making representations to the federal government without precluding efforts to directly lobby ministers and government departments. More recently, the Canadian government's trade policy review of 1983 and 1985 involved consultations with groups and individuals representing private sector interests. Similar consultations with the private sector occur in the United States; for example, the Office of the United States Trade Representative (USTR) has a director for private sector liaison.

Canadian and U.S. private sector groups have an important role in the promotion and management of the Canada/U.S. trade and economic relationship. Direct contacts between groups and individuals across the border serve a number of specific functions including the gathering and exchange of information, the encouragement of research and discussion on economic and trade policy, and the promotion of trade and economic development in the two countries. These groups include research organizations, universities, and business and industry associations. Some of these functions are also carried out by both Canadian and American public relations and consulting firms located in Washington which monitor developments in trade and other policy areas in the U.S. that are of special interest to Canadian firms and industries.

In the area of research, a number of Canadian institutes have formal and informal contacts with research groups in the United States. They may conduct joint research into subjects of mutual interest to both countries – which range from the very broad, such as how to manage the overall bilateral relationship, to the rather specific, such as how to standardize documentation involved in the business transactions between the two countries. They may also co-sponsor conferences on the bilateral relationship or exchange ideas very informally. For example, the Canadian Institute of International Affairs has conducted joint research with a number of American universities and, since 1971, has sponsored, with the Council on Foreign Relations, the Lester B. Pearson Conferences on the Canada/U.S. relationship which at times have covered economic issues. The Institute for Research on Public Policy maintains links with the newly-established Institute for International Economics in Washington, the Johns Hopkins School of Advanced International Studies, and the Center for Strategic and International Studies at Georgetown University and has rather less formal associations with the Brookings Institution and the American Enterprise Institute (AEI). The Canadian Organization for the Simplification of Trade Procedures (COSTPRO) has undertaken a joint project with its U.S. counterpart, the National Committee of International Trade Documentation (NCITD), to simplify transborder document processing between the two countries based upon international standards. Perhaps the most structured of the bilateral research efforts to date has been that conducted by the Canadian-American Committee which since 1957 has been jointly sponsored by the C.D. Howe Research Institute in Canada and the National Planning Association in the United States. Overall, there appears, nevertheless, to be a lack of awareness and co-ordination of the research being conducted by these various groups.

In addition, various business and industry groups in Canada have established their own arrangements for the exchange of information with their U.S. counterparts, and have prepared their own research and submissions to government with regard to the Canada/U.S. relationship. The Canadian Business and Industry International Advisory Council (CBIIAC),[10] the major umbrella group representing

Canadian business interests, recently made a submission to the Canadian government on the subject of Canada/U.S. consultative arrangements. The Business Council on National Issues (BCNI), comprising the executive officers of leading Canadian corporations, has also in recent years become involved in trade matters with one of its Task Forces actively undertaking or sponsoring studies of the bilateral economic relationship.

Contacts between Canadian and U.S. business and industry associations take a variety of forms, ranging from the exchange of regular publications to regular and continuous contact and the exchange of board members and regular meetings between presidents. For example, the Canadian and American Chambers of Commerce co-sponsor a joint Committee on Canada/United States Relations which meets semi-annually to discuss a broad range of issues of mutual interest, and subsequently submits reports to the two governments. The Canadian Manufacturers' Association and the National Association of Manufacturers of the United States have a less structured arrangement, meeting annually for an informal discussion and exchange of views. Presidents of some of the larger trade and industry associations, such as the Canadian Export Association, make regular trips to Washington to meet with industry associations as well as with both American and Canadian officials with responsibility for trade between the two countries. Many sectoral associations have formal or informal contact with their U.S. counterparts; for example, the Canadian Association of Equipment Distributors is patterned after its U.S. counterpart, the Associated Equipment Distributors. The two associations exchange one board member and attend each others' committee and annual meetings. Often, the closeness of relationships is limited because these counterpart national associations represent competing interests. However, they can provide valuable sources of information on market and legislative developments in the United States, as well as potential allies in influencing both the U.S. and Canadian governments.

Finally, a very few of the larger Canadian firms, such as Northern Telecom, Alcan, and Seagram, have set up public relations offices in Washington to establish contacts with American officials and to monitor events on Capitol Hill which are of particular significance to their specific business interests. Many more Canadian firms hire American consultants on a continuing or ad hoc basis to perform a similar function. While the ability of Canadian business to make representation and gather information in Washington appears to have improved in recent years, there appears to be a continuing inadequacy of information with regard to events in the United States capital and an inability to identify and make contact with congressmen and staff members who are interested in Canada, and with American constituencies or constituent groups that share Canadian interests.

An important means of improving the awareness of U.S. citizens in general, and U.S. officials and elected representatives in particular, to Canadian interests and problems is through Canadian studies programs in U.S. universities. Courses related to Canada are taught at colleges and universities in most states and the District of Columbia; the only states where there is no activity are Hawaii, New Mexico, Nevada, and Wyoming. There are twenty institutions with formal Canadian Studies programs[11] and another 380 institutions report some involvement in Canadian studies (Association for Canadian Studies in the U.S. 1983). However, courses offered tend to focus on areas other than trade and economics. Recognizing the potential value of Canadian Studies programs in the U.S., the Business Fund for Canadian Studies was set up in 1980 on the initiative of Northern Telecom. The aim of the Business Fund is to promote these programs by increasing Canadian corporate donations to them.[12]

On the Canadian side, university programs focused on the United States are less structured. All Canadian universities offer courses related to the United States in a variety of faculties, but at present, there are only four universities which offer degrees in American Studies – the University of Alberta, Carleton University, Mount Allison University, and the University of New Brunswick, and only one, McGill, has a program in North American Studies.

ELEMENTS OF AN EFFECTIVE BILATERAL MANAGEMENT SYSTEM FOR THE FUTURE

As noted above, many elements of an effective system of managing Canada/U.S. economic and trade relationships are already in place. Some are operating very well and should be left alone; others could be elaborated or strengthened. Some new elements might be designed and put in place both bilaterally and on a multilateral basis.

It is useful to examine those existing and possible additional elements in the management system in the light of the various functions that they should be designed to serve. These various functions can be distinguished in different ways. There are at least four essential functions in an effective management system which could be identified:

1 Facilities to assist information flows between the two federal governments, amongst provincial and state authorities concerned, and among the private sector interests that are involved. At the federal level, the embassies and consulates of both countries have been strengthened over recent years to serve this function in various ways. As noted above, provincial and state governments have progressively opened new offices across the border to meet their particular needs; and, in Canada at least, there has been a degree of improvement in mechanisms for facilitating the flow of information between Ottawa and the provincial capitals. In the private sector, several constructive proposals have been made recently to improve facilities for gathering and disseminating information to business corporations and others. For example, the President of Northern Telecom recently suggested the need for a centre in Washington which could monitor and provide information on developments in the United States of special interest to Canadian business firms.

2 Facilities for some kind of co-operative research and analysis by independent bodies of issues of bilateral concern designed to identify and assess the interests involved on both sides and to suggest to the authorities in each country constructive solutions to bilateral problems. As noted above, there are a variety of public policy research organizations functioning in this area, and in several universities in both countries there are a number of special programs devoted to the study of bilateral problems. What seems to be lacking is a more structured and continuing program for co-operative research and analysis of bilateral trade and economic issues. The concept of such a program of co-operative research and analysis is not new. In 1978, joint conferences on Canadian/U.S. economic relations were held in Washington and Ottawa between the Brookings Institution and the Institute for Research on Public Policy. At these conferences, it was proposed that a permanent program be established to sponsor joint research on issues of bilateral interest. For such a program to get off

the ground and to be successful, it seems clear that a degree of encouragement and support by the two federal governments, and also by others, is essential.

3 Mechanisms for continuing consultations between the two federal governments concerning policies that affect the interests of the other country. As noted above, the regular annual meetings of the joint Ministerial Committee on Trade and Economic Affairs, for various and presumably good reasons, were discontinued after 1970. It is difficult, from outside, to assess the effectiveness of the existing facilities for joint consultation between the two governments. But it does appear remarkable that some more formal and permanent structure for consultations is not in place between two governments, and that the present institutional process does not embody some formal commitment by the two governments to consult each other in advance on the development of policies that have a significant impact on the interests of the other.

4 Facilities for the resolution of bilateral disputes. There exists a variety of such facilities in the multilateral institutions which both countries actively participate and support, such as the GATT and the OECD, but it might be desirable and practicable to build upon these multilateral facilities some kind of additional procedures for dealing with uniquely bilateral disputes in trade and economic areas. It would seem timely for a new and more thorough examination of such possibilities.

BILATERAL TRADE LIBERALIZATION

It is widely accepted that there is considerable room for further liberalization of bilateral trade and that this would serve the interests of both countries. On the Canadian side, improved access to the much larger U.S. market and greater competition from U.S. firms would serve to strengthen the productivity and efficiency of Canadian industry. The U.S. would also benefit somewhat from freer access to the Canadian market and would benefit directly and indirectly from a more vibrant Canadian economy. Efforts to liberalize bilateral trade could take place within existing multilateral arrangements or through the establishment of some new bilateral negotiating mechanism.

No initiatives were launched at the 1982 GATT Ministerial Meeting for a further major round of tariff and trade negotiations. However, there is evidence, more recently, of strong interest in planning for such negotiations, perhaps towards the end of the 1980s. It has been reported that the subject has been raised in the quadrilateral meeting context and also that Prime Minister Nakasone of Japan has been actively calling for a new round of GATT trade negotiations in order 'to consolidate the free trading system and to inject renewed confidence in the world economy'; this initiative was also endorsed by President Reagan and former Prime Minister Trudeau.[13]

At the same time, there has emerged in Canada in recent years a considerable body of opinion that favours some form of special trade arrangements with Canada's largest trading partner. Reports issued over the last few years by the Senate Committee on Foreign Affairs and the C.D. Howe Institute, amongst others, have favoured proposals for a broad Canada/U.S. free trade arrangement of the kind envisaged in GATT Article XXIV and modelled, perhaps, on arrangements within the European Free Trade Association. More recently, the discussion paper issued by the Department of External Affairs, *Trade Policy for the 1980s*, has suggested possibilities for bilateral negotiations aimed at the liberalization of cross-border trade and arrangements for dealing with bilateral trade issues on a sectoral basis. The Minister of State for International Trade has stated that an analysis of such possibilities will proceed within the Canadian government. From the U.S. side, responses by senior trade policy officials have been positive, although noncommittal.

The success of new efforts to liberalize bilateral trade requires the active involvement of provincial and state governments and private sector interests on both sides of the border. On the Canadian side, an examination of the current involvement of provincial governments in trade policy development might indicate the need for the creation of a formal structure for ongoing consultations between federal and provincial authorities – perhaps similar to those established in Canada during the Tokyo Round mentioned above. In both countries, the private sector could make a valuable contribution by conducting research and analysis, independent of government, into the possibilities for trade liberalization in particular sectors, and into certain problem areas in the trade relationship.

Any analysis of possibilities for liberalization of cross-border trade, or special arrangements for dealing with bilateral trade issues, must take carefully into account both Canadian and U.S. obligations under GATT, as well as third-country interests. The MFN obligations of both countries, with respect to other GATT countries in particular, will inevitably set some constraints on any bilateral Canada/U.S. arrangements, despite the fact that the integrity of the MFN principle has already been eroded by regional trade arrangements involving other GATT members.

Constructive new Canada/U.S. bilateral trade arrangements on sectoral or some other more comprehensive basis need not necessarily, of course, involve arrangements that would be preferential in their nature, give rise to inconsistency with the other GATT obligations of the two countries, or damage third country interests. In his speech to this workshop, former Ambassador Jake Warren addressed this issue as follows:

> Conceptually, some sectors or subsectors might be found where tariff removal and restraint in the application of nontariff and comparable measures could be extended to other trading partners, immediately, or over time, without serious consequences for either of the bilateral partners. In other cases arrangements might take a conditional MFN or 'open ended' character. And some situations might suggest that formal exceptions should be sought from the normal rules of GATT. Indeed, compensation could be considered if the foreseen benefits significantly outweighed the estimated international costs.

CONCLUSIONS

Given the underlying mutual confidence and the similarity of basic objectives and approaches in Canada and the United States, solutions to bilateral issues can usually be found through a process of clarification of the interests involved, constructive analysis of each other's objectives and interests, and continuous cross-border dialogue involving the various levels of government in both countries and also private sector interests. Where entirely satisfactory solutions cannot be achieved on particular issues – and this is not always possible – the two countries should look for some tolerable *modus vivendi*, assisted where appropriate by whatever facilities are available for research, consultation, arbitration, or conciliation.

However, the satisfactory resolution of bilateral issues on a continuing basis requires an underpinning of adequate structures for the management of bilateral trade and economic relations as no country, especially smaller ones, can or should rely on a management system that rests mainly on the interactions between individuals on the two sides, no matter how highly placed and well-qualified they may be.

As reviewed above, management structures already exist both on a multilateral and bilateral basis, but they might well be reappraised in light of today's problems and issues, and especially in view of those likely to emerge over the next few years. There appears to be a need for improved mechanisms on both sides of the border for gathering and disseminating information about developments of special interest to the private sector. Further and better co-ordinated programs for research and analysis of problems of common concern may also need to be developed. Existing mechanisms for consultation between the two governments also might need to be strengthened, especially with respect to advance notice of policy initiatives by one country that can have a significant impact on the interests of the other. While the GATT dispute resolution processes operate reasonably well, there may well be a need for supplementary facilities to deal with issues of unique bilateral concern. If and when plans go forward for another round of GATT tariff and trade negotiations, a good framework would be created for further concerted efforts to reduce or remove tariffs and other barriers to bilateral trade either on a limited sector-by-sector basis or through a more comprehensive approach. However, if these plans do not proceed, or proceed in a piecemeal, slow, and cumbersome fashion, the two countries could consider ways of proceeding within a bilateral framework with new efforts to liberalize cross-border trade and reduce distortions in trade flows.

The elaboration of institutions to manage the bilateral relationship should be pursued not for their own sake but rather in light of the need to respond to the needs of the two countries and to the changes in the problems and issues facing them. Adequate structures for management are particularly important from a Canadian perspective because of the imbalances inherent in the relationship. Given the magnitude of U.S. economic involvement in Canada, these structures are important for the larger partner as well. A stable, prosperous and predictable neighbour must necessarily be an integral part of global U.S. economic and political strategy.

NOTES

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1 For a brief decade in the middle of the 19th century, the Reciprocity Treaty removed customs duties on most so-called 'natural' products but only on a few manufactures. After its abrogation by the United States in 1866, and for seventy years thereafter, the United States levied high tariffs on most imports from Canada, except on needed raw materials. Partly in response, Canada increased its tariffs on most imports from the United States, under the 'National Policy' put in place by Sir John A. MacDonald's government in 1878. On both sides, the highest rates allowed by tariff legislation were applied to bilateral trade as well. On the Canadian side, meanwhile, preferential tariff arrangements were put in place for trade with British Empire areas. During this long period, no bilateral trade agreements existed between Canada and the United States. For the most part, relations between the two countries were conducted through London, although the Canadian government effectively controlled the operation of its own commercial policies.

2 A.D.P. Heeney, Livingston T. Merchant, *Canada and the United States: Principles for Partnership*, Ottawa: Queen's Printer, 1965. A.D.P. Heeney was Canadian ambassador to Washington and Livingston Merchant, the U.S. ambassador to Ottawa. The Merchant-Heeney Task Force to study the bilateral relationship was established in 1964 as a result of discussions between Prime Minister Pearson and President Johnson in Washington, D.C. between 21-22 January 1964.

3 The different federal structures in Canada and the U.S. have posed considerable difficulties in managing relations between the two countries. On the Canadian side, decisions taken by the responsible ministers are almost automatically translated into government policy. U.S. secretaries can offer no such guarantee, and a number of agreements, for example, the 1979 East Coast fisheries agreement, failed to be ratified by Congress. A somewhat parallel problem in Canada is the need to obtain the

approval of the provinces for certain agreements entered into by the federal government – an example being the agreement signed between the governments of Canada and British Columbia prior to the signing of the Columbia River Treaty in the early 1960s. Although the federal government has the sole authority to enter into treaties with foreign governments, the Canadian parliament cannot legislate to implement a treaty if the subject matter falls within the exclusive legislative jurisdiction of the provinces.

4 The others are: the United States General Relations Division, United States Transboundary Division, United States Marketing and Customs Information Division, United States Trade Investment Development Division and the United States Programs Division.

5 The Committee membership initially consisted of the secretary of state for external affairs and the ministers of finance, trade and commerce, and either the minister of agriculture or the minister of fisheries from Canada; and from the U.S., the secretaries of state, treasury, agriculture and commerce. In 1961, the U.S. secretary of the interior was added, and in 1963, the Canadian minister of industry.

6 For a more detailed summary of bilateral agreements and governmental bodies at the federal level refer to William R. Willoughby, *The Joint Organizations of Canada and the United States*, Toronto: University of Toronto Press, 1979.

7 Ontario and Alberta are co-ordinating views on the general bilateral trade and economic relationship, while Quebec and British Columbia are examining high-priority Canada-U.S. trade issues. Saskatchewan and Nova Scotia are preparing a paper on the interplay between the Department of External Affairs, the regional offices of the federal government, and the provincial governments in international trade and economic policy.

8 Location of provincial offices in the United States:

British Columbia: Los Angeles, San Francisco, Seattle;
Alberta: Houston, Los Angeles, New York City;
Ontario: Atlanta, Boston, Chicago, Dallas, Los Angeles, New York, Philadelphia, San Francisco;
Quebec: Atlanta, Boston, Chicago, Dallas, Lafayette (Louisiana), Los Angeles, New York;
Nova Scotia: New York, Portland.

9 State offices in Canada: State of Hawaii Travel Promotion Office in Delta, B.C.; New York State Department of Commerce offices in Montreal and Toronto; Georgia Department of Industry and Trade office in Toronto; State of New Jersey office in Montreal; New Hampshire Vacation Office, Montreal; Vermont Information Centre, Montreal.

10 The Canadian Business and Industry International Advisory Council founded in 1977 is the major umbrella group representing the Canadian business community in the area of foreign policy. Its members include the Canadian Chamber of Commerce, the Canadian Council of the International Chamber of Commerce, the Canadian Manufacturers' Association, the Canadian Association for Latin America and the Caribbean, the Canadian Committee of the Pacific Basin Economic Council, the Canadian Export Association and the Canadian Import Association. CBIIAC was founded to promote co-operation amongst the Canadian business community and to co-ordinate viewpoints for presentation to government. Policy positions are developed in steering committees for which responsibility is divided amongst the member associations to avoid duplication of efforts. Canada/U.S. matters are discussed in the Committee on Canada-United States Relations (described below) which, within CBIIAC, is the responsibility of the Canadian Chamber of Commerce. The members of CBIIAC are also involved in the public policy process independently; and some, such as the Canadian Council of the International Chamber of Commerce, liaise with international business organizations. CBIIAC itself is a member of an international organization, the Business and Industry Advisory Committee to the OECD. This provides an opportunity for Canadian business leaders to meet with their U.S. counterparts in international fora.

11 Institutions in the United States offering Canadian Studies programs (major, minor, certificate and/or graduate programs):

Boise State University, Bridgewater State College, Brigham Young University, Bucknell University, California State University-Sacramento, Duke University, Glassboro State College, Johns Hopkins SAIS, Michigan State University, Northern Montana College, Plymouth State College, St. Lawrence College, State University of New York at Plattsburgh, Trinity College, University of Maine at Orono, University of Rochester, University of South Western Louisiana, University of Vermont, University of Washington, Western Washington University.

12 A 1980 study by the Business Fund on the funding of Canadian studies programs in U.S. universities revealed that only 6 per cent of the funding came from Canadian corporations and only 23 per cent from the Canadian government. Thus, more than 70 per cent of the funding of Canadian studies in the U.S. came from U.S. sources – government, corporations and foundations. The amounts provided by Canadian sources for studies related to this country appear somewhat meagre compared to much larger amounts being donated by such countries as West Germany and Japan to promote studies of their countries in the United States. See *Who Speaks for Canada*, Toronto: Business Fund for Canadian Studies in the United States, 1980.

13 *New York Times*, 11 November 1983, p. 1, and statements issued in Tokyo during visits by President Reagan and Prime Minister Trudeau.

Comments

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Not being a political scientist, I am perhaps not the ideal person to comment on the papers by Rodney Grey and John Curtis. The adherents to the school of bureaucratic politics – whereby 'where you stand depends on where you sit' – will be reassured, however, to note that former negotiator Grey believes the fundamental requirement is for statesmanlike negotiators, while policy-researcher Curtis finds as one major conclusion that more funding is needed for policy research institutes.

The authors have provided a useful enumeration of approaches to, and possibilities for improvement in, institutional arrangements for negotiations. My only observation on these arrangements is that they should depend on the objective of negotiations. If that objective is modest, concentrating mainly on resolution of ad hoc problems that may surface, then a low level commission of some sort would seem appropriate. It is difficult to see under existing law how a negotiating entity could be given arbitration power, although this might be a possibility. An entity involving ministerial level policymakers would appear inappropriate in the scenario of modest goals; cabinet officials are already overcommitted for international meetings.

If the goal of negotiations is to be a serious move toward a free trade area, however, or even toward a set of major sectoral agreements on free trade, the negotiating modality should be forceful. There should be a time-limited program of negotiations at high levels. Such negotiations might involve a two- to three-year program beginning with trade authorities and subsequently involving finance and foreign ministers. This strategy would amount to a Canada/U.S. round of negotiations, rather than a more leisurely and ongoing bilateral trade commission.

With the liberty granted by the organizers of the conference, I would like to turn the remainder of my comments to the substance rather than the institutional modality of Canada/U.S. trade negotiations. A fundamental issue concerning the trade relationship is the more general choice between bilateralism and multilateralism.

The process of multilateral trade negotiation is currently at a hiatus. The November 1982 GATT Ministerial meeting failed to get the machinery moving for a new general round of negotiations. A logical way to move ahead at this juncture would be through interim bilateral negotiations. For example, at the Ministerial meeting the United States sought to move ahead in new areas, including services, export performance requirements on direct investment (not covered by GATT), and high-technology sectors. U.S. and Canadian negotiators could possibly make progress in these areas that would serve as a model that could later be generalized within the GATT.

Over the longer run, however, a difficult choice must be made between bilateralism and multilateralism. Consider either a free-trade area between Canada and the United States, with zero tariffs, or a sectoral free-trade arrangement involving several sectors and modeled on the automobile pact. Either approach contradicts the U.S. (and perhaps Canadian) tradition of most-favoured-nation (MFN) treatment and multilateralism, even though technically a zero-tariff area would be compatible with GATT while sectoral agreements would require a GATT waiver. The United States has already violated the MFN tradition in its recent Caribbean Basin Initiative, and similar departures may be in store for U.S. trade relations with Israel. If the United States entered a free trade area with Canada, many abroad would ask whether the United States was turning to a basic approach of regional-bloc trading. There could be repercussions if this action seemed to justify the increase of bloc-regionalization of other areas. It could be misleading to calculate that no further room remains for additional integration and trade diversion in Europe (including the Mediterranean, African, and Commonwealth states). New initiatives between Japan and other Asian countries might emerge if regionalization became the new direction in global trade policy.

Some politically important trading partners could be adversely affected. Latin American countries would feel left out in the cold. Trade diversion could jeopardize Mexican producers of petrochemicals and steel, Brazilian producers of steel, and perhaps other country-sectors that are less obvious.

The same principle of MFN treatment and multilateralism casts doubt on the appropriateness of the view, mentioned several times in this conference, that Canada has been unfairly affected as an innocent bystander when U.S. safeguards are applied in response to new import flows from third countries. This viewpoint fails to recognize that one of the central objectives of MFN treatment is to help keep the trading system open by mobilizing pressure from all foreign suppliers against protection rather than allowing protection to be focused on the newcomers (the 'selectivity' issue in safeguards negotiations).

In short, policymakers in both countries must carefully consider the potential contradictions of Canada/U.S. free trade against the MFN tradition of both countries. They must also consider what kind of signal bilateral integration would send to the international trading system, and what repercussions might follow for some important developing countries in particular and the outside world more generally.

Ironically, Canada/U.S. trade is already largely free. After the Tokyo-Round tariff cuts are fully implemented, 80 per cent of Canadian exports to the United States will be duty free and 95 per cent will face either free entry or tariffs lower than 5 per cent; the corresponding figures for U.S. exports to Canada will be 65 per cent and 91 per cent.

Despite much criticism of the system of contingent protection, it is not evident that nontariff barriers are of great significance either. Stern's paper for this conference enumerates areas of major friction, yet for the NTBs he cites, the case of Maine potatoes is in doubt, that of lumber is now resolved, and that of subway cars has been withdrawn. Wonnacott's paper from the Canadian point of view focuses on future possibilities but does not present a damning bill of particulars on current nontariff barriers. With considerable justification, U.S. and Canadian authorities could adopt the General Gavin solution for the Vietnam War: declare that the battle for free trade has already been won.

Nonetheless, scope remains for further liberalization. The Canadian government has proposed sectoral free trade in four areas: textiles, petrochemicals, speciality steel, and urban transit equipment. Tariffs remain high in some of these sectors – on the order of 20 per cent in textiles and 12 per cent in processed petrochemical goods.

However, even for a sectoral approach issues remain. Trade diversion is a real possibility. U.S. producers of textiles and specialty steel seem unlikely to accept free entry from Canada unless they are assured that there will be corresponding reduction in imports from other areas (through adjustment of quotas in the Multi-fiber Arrangement, for example). Although U.S. producers could seek additional sales in Canada, the firms affected by imports could be different from those achieving new exports, with resulting pressure for protectionist trade diversion. As a consequence, imports from Brazil, Korea, Mexico, and other newly industrializing countries in particular could decline.

The MFA is already a regressive arrangement that permits unlimited entry of textiles and apparel from rich countries while limiting imports from developing countries. A bilateral free trade arrangement in textiles would seem to move further in this distorted direction by eliminating tariffs to North-North trade, adding another disadvantage to North-South trade.

As for petrochemicals, U.S. producers seem unlikely to accept a free trade arrangement unless Canada changes its National Energy Policy to end favourable pricing for feedstocks.

A more ambitious general free trade area, in turn, would not be very meaningful unless it set up machinery for elimination of nontariff barriers and for the resolution of investment misunderstandings, considering that tariffs are already so low. Moreover, there are certain dynamics to a true free trade arrangement that require consideration.

A free trade area would imply greater opportunities and risks for Canada than for the United States. The benefits would be greater for Canada because the scale of the U.S. market is already adequate for efficient production, whereas a central benefit to Canadian firms would be the assured access to a continental market with scale far greater than the Canadian market, permitting production at efficient scale. Integration would increase the U.S. market by only 10 per cent;

it would multiply the Canadian market tenfold. Studies of minimum optimum scale have shown that many industrial sectors require scale on the order of 5 to 10 per cent of the U.S. market for efficient production (Scherer 1980, 96), suggesting that efficient scale within Canada in isolation is difficult, especially if monopoly is to be avoided.

The asymmetry of market dimensions means greater opportunities from free trade for Canada than for the United States, even under constant returns to scale. With comparable tariff levels, the increased market opportunity for the typical Canadian firm as the result of free trade would be 100 times as great as for the typical U.S. firm. That is, the market opening per firm equals: $\Delta t(C_u)/N_c$ for a Canadian firm and $\Delta t(C_c)/N_u$ for a U.S. firm, where t is the tariff rate, C is market size (consumption), N the number of firms, and subscripts c and u refer to Canada and the United States respectively. Because $C_u = 10(C_c)$ and $N_c = 0.10\ N_u$, per-firm market opening is 100 times as large for Canadian firms as for U.S. firms.

This phenomenon, combined with Canada's greater gains from new economies of scale, suggests U.S. bargaining leverage in any negotiations, because it is Canada that has the more to gain. Viewed alternatively, free trade would have minimal impact on the terms of trade for the United States but could improve them proportionately more for Canada.

However, if the potential gains are greater for Canada, so are the risks. Because U.S. firms already have large scale advantages, Canadian firms in many sectors may be hard pressed by new competition. Indeed, integration experiences have often shown fears of smaller partners against inundation of manufactured goods from the larger partners (for example, in Latin American integration experience). European integration was successful in part because it involved partners of comparable economic size.

A true Canada/U.S. integration would seem likely to lead to situations in which Canadian firms produced only a small percentage of their output for the home market and a large percentage for export to the United States. This structure would be inherently risky for Canada. As long as the two countries have separate legislatures, there will be political risk to the development of Canadian industry on the basis of an export-platform structure. Investment decisions appropriately would apply some risk discount to production premised heavily on exports to the U.S. This caveat applies especially to those sectors in which either employment size is large, giving strong political influence, or import penetration is high (Cline 1984).

A safer strategy would be Canadian production premised on perhaps 30 per cent to a maximum of 50 per cent reliance on the U.S. market, oriented toward the regional market in the U.S. snow belt rather than the entire U.S. market. Even in this approach risk would remain, especially if the snow belt remains a high unemployment area.

The broad implication of these observations is that Canada/U.S. negotiations can be a helpful step to advance the currently moribund GATT negotiations, but that careful consideration must be given by each country to the long-run consequences before moving ahead into sectoral or generalized free trade on a bilateral basis.

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Comments

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As I read the two interesting papers concerning the potential for reforming institutions for Canada/U.S. trade relations, I felt that the two authors are somewhat ambivalent about the necessity for any new institutions. Since previous commentators have dealt very adequately with some of the particular GATT problems, including MFN, I will turn to a somewhat different approach in my remarks.

What I intend to do is to try set up a schema of analysis for the question under consideration, and to indicate some aspects that bear on the particular questions under that schema, although I will not by any means be complete. I will indicate the schema and then hope that this will provide some direction in case others want to go further with that analysis.

It seems to me that there are three basic questions which need to be asked:

- Do institutions matter?
- Even if the institutions do matter, is a change needed in the particular context of institutions for Canada/U.S. trade relations?
- If a change is needed, what might be the direction of that change? For example, should it be towards a bilateral approach, or a multilateral approach? (It is this subject which could bear considerably more attention.)

Do institutions matter?

It has been my experience that there is a tendency on the part of some persons, and often on the part of governmental officials, to overestimate the importance of individual personal activity in international diplomacy and affairs, and to underestimate the importance of institutions. Thus, one sometimes sees statements that 'if personal will and skill is present, the institutions won't matter; and if personal will and skill is not present, no institution can make up for the lack.' These tend, in my view, to underemphasize what I think is the essential reality of human institutions, namely, that institutions must be designed for human beings who are considerably less than perfect. Even government officials 'lie, cheat, and steal', and thus international institutions must take account of that fact.

Obviously, skilful individuals will make even weak institutions work better, and weak institutions will not totally make up for the lack of skilful individuals. Nevertheless, institutions do have an impact on the context, channeling, traditions, and attitudes of an ever-changing cast of individuals who represent their governments. In short, I conclude that institutions do indeed matter, and that it is worthwhile giving some attention to them. I particularly have noticed this for some years in the context of multilateral institutions and, of course, the GATT. For example, the GATT dispute settlement mechanism leaves a great deal to be desired, and there are ways that that particular institution (as well as other aspects of GATT) might be made moderately more effective, although better institutions will not work miracles.

Is change needed in the institutions?

The papers present an impressive array of existing Canada/U.S. bilateral institutions, as well as the use of multilateral institutions, as instruments of channeling and influencing Canada/U.S. relationships. I do not pretend to be an expert on these, and consequently I probably have the least to say with respect to this particular question. It seems to me that there are three alternative conclusions that could be considered:

- That the present institutions suffice.
- That whether present institutions suffice or not, there is no particular need for institutions in this particular subject matter area (for some reason or other).
- Some change is needed, because the existing institutions do not seem to be adequate to the tasks either at present or contemplated for the future.

The middle option presented above might be the case if there were no real difference in policy or international economic objectives between the United States and Canada. However, I do not believe this to be the case. I believe there are fundamental differences that cannot be resolved simply by understanding the other party, or understanding one's real long-term objectives. Indeed, although the differences in policy between the United States and Canada may be considerably less than that between the United States and/or Canada vis-à-vis other countries, nevertheless there are enough significant differences between the two neighbours that I would strongly suppose that institutions do play an important role. Rejecting the middle option, however, does not preclude a choice of either the first or third possibilities. The richness of existing Canada/U.S. institutions presented in the papers might well lead to the first conclusion.

If change is needed, what direction should it take?

This is the most complex of the questions if the answer is yes. There are various alternatives and dimensions that might be considered. For example, institutions could be primarily designed for aiding the process of consultation between the governments, or in the alternative be designed to specify substantive rules (such as carve-outs for Canada when the United States applied an escape clause case). On the other hand, one could think in terms of institutions being either rule-oriented or not. For the institutions to be rule-oriented, one would try to develop rules at the outset, or design the institution so that rule development could occur over a period of time. Particular rules of international economic conduct of the two countries concerned would be specified in a treaty-type arrangement. If the institutions were not to be rule-oriented, then more reliance would be placed on a statement of general principles, perhaps associated with a consultation mechanism and a requirement of prior notice before either government took action affecting the other.

One of the most perplexing questions of the Canada/U.S. relationship is whether it is wisest to place them in primarily a bilateral context, or a multilateral context. (Logically, one could also consider a unilateral approach, but this is exactly what institutions are designed to minimize.)

In considering this question of bilateralism versus multilateralism, one can easily imagine a matrix such as the one that appears as Table 1.

My following comments are elaborations on the somewhat elliptical phrases used in this chart. Obviously, additional reasons can be inserted in each of the various 'cells' of the chart, and this short paper is not designed to be a thorough 'options paper' for the bilateralism versus multilateralism question.

First, as to a bilateral approach: although I cannot be an expert on the Canadian viewpoint, I can point out several facets that Canadian policymakers might be considering if it were decided wise to attempt additional bilateral mechanisms between the U.S. and Canada. Obviously favouring such an approach is the importance of U.S. trade to Canada, particularly its relative importance compared to the importance of that bilateral trade to the U.S. Thus, Canada could see advantages in having special preferences, such as in the Auto Pact, or other sectorial arrangements. Canada also would like to avoid having U.S. escape clauses or other trade actions apply against its products.

On the other hand, Canada may have some trepidation in putting too much dependence on the United States for its trade. This could make Canada even more vulnerable to some of the whims and vagaries of the United States' politics and government action concerning international trade. Canada might therefore prefer to diversity some of its trading relationships.

In addition, because of the asymmetry of the Canada/U.S. trading relationship, the U.S. holds many more bargaining chips on trade as well as many related matters. Thus in bilateral dealings, Canada might find itself at something of a bargaining or negotiating disadvantage.

From the Canadian point of view, there are also some pros and cons relating to a multilateral approach. In favour of a multilateral approach can be mentioned that Canada might be able to at least part-

TABLE 1
Bilateralism/multilateralism matrix between Canada and the U.S.

Approaches	Canada viewpoint	U.S. viewpoint
Bilateral		
Reasons *Pro*:	Importance of U.S. trade. Obtain special (non-MFN) treatment (carve out).	Major border & trading partner.
Reasons *Con*:	Too much dependence on U.S. – need to diversify. U.S. holds more bargaining chips.	Affects U.S. relations with other countries. Issues need broader, more universal approach. Substantive preferences could be contrary to MFN obligations, and a GATT waiver might be diplomatically costly.
Mulitateral		
Reasons *Pro*:	Working in concert with other nations may redress power imbalance. Canada's successful leadership role in GATT.	Helps U.S. manage its other relationships. Efficiencies of government effort to handle issues which arise.
Reasons *Con*:	(Mirror image of Bilateral 'Pro'.)	(Mirror image of Bilateral 'Pro'.) Yields to least common denominator GATT consensus approach.

ly redress some of its bargaining disadvantage vis-à-vis the United States, if it were able to work in concert with a number of other nations in GATT or other fora. In addition, Canada's successful leadership role in GATT during the several decades of GATT's history, should be counted as part of the pluses for continuing to pursue a multilateral approach. Against a multilateral approach, from the Canadian viewpoint, of course, can be mentioned reasons similar to those which are stated as favouring a bilateral approach.

From the U.S. point of view, some of the issues are somewhat different. In favor of a bilateral Canada/U.S. approach, in the eyes of the U.S., is the fact that Canada is the most significant trading partner to the United States, that the United States and Canada share a long border, that they have many societal and economic attributes that are similar, and that a solid relationship between the two is certainly a strong desideratum from the point of view of the United States, as well as Canada.

On the other hand, from the U.S. point of view there are some major disadvantages of too much bilateralism. The U.S. must take into account the effects which actions in a bilateral context have upon the United States' relations with other countries. In many cases, U.S. relations with other countries are affected by geopolitical considerations, which tend to downgrade the importance of purely trade matters. If by developing particular preferences in favour of Canada, the United States would disturb relationships with other countries, the U.S. would have to count that as a negative.

Likewise, the United States is a major supporter of the GATT multilateral system and related agreements. Although consultation and other procedural matters could certainly be developed on a bilateral basis, without too much infringement on the GATT principles, nevertheless if there were to be substantive preferences for Canada, there would be considerable potential that these would be contrary to the MFN obligation of GATT. Although a rather complete free trade area might be deemed to comply with Article XXIV of GATT, one can imagine that any preferential system likely to be implemented in a forseeable time frame would fall sufficiently short of such completeness as to provide an opportunity from other nations in the world to be strongly critical of it. Such criticism could be used as a shield against the United States' policies which have been attempting to minimize the development of preferential systems elsewhere in the world. In order to obtain a GATT waiver, diplomatic chips would have to be expended which might be proved costly.

From the U.S. point of view, continuing a major portion of Canada/U.S. economic relations in the multilateral context has a number of advantages. It helps the United States to manage its relationship with other countries, avoid some of the negative policy results mentioned above, and might have a role in promoting the efficiency of U.S. government activity on international trade matters, since many of the issues which arise in the Canada/U.S. context also arise in the context of other countries and might more efficiently be handled on a more general basis.

On the other hand, from the U.S. point of view the multilateral approach might have some negatives. Canada and the United States may be in more agreement on a number of substantive trade policy issues, than would the U.S. and many other countries in the world. To base its relationships with Canada only on the multilateral context, often leaves the United States necessarily yielding to the 'lowest common denominator' of the broader community. This may prevent important and necessary action in trying to manage an increasingly interdependent world in North America.

Obviously, the matrix structure above tends to focus on the end points of a 'spectrum'. There are numerous in-between possibilities which could be analysed and developed. The challenge, it seems to me, is for Canada and the United States to flesh out the policy matrix outlined above, and then to try to steer a course somewhere between the extreme of bilateralism on the one hand, and the extreme of multilateralism on the other hand. The goal would be to try to develop a course which would tend to minimize the negatives from either point of view, while maximizing the affirmatives in either point of view. Since some of those negatives directly contradict some of the affirmatives, this will be no easy task, but it is not substantially different than the task which governments find themselves pursuing in a wide variety of affairs. Conceivably a satisfactory approach might involve the bilateral development of measures which could be opened to other nations on a MFN basis.

Investment frictions and opportunities in bilateral trade relations

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INTRODUCTION: U.S. AND CANADIAN STATEMENTS OF INVESTMENT POLICIES

In 1980, a major dispute erupted between Canada and the United States concerning aspects of Canada's foreign investment policies. Bilateral relations have since improved as both sides responded to the task of trying to maintain and strengthen a trade relationship which has been larger and more durable than that between any two countries elsewhere in the world. Nevertheless, policy differences over investment issues remain, and will likely remain for the foreseeable future.

This paper reviews recent Canada/U.S. investment policy differences and their relationship to Canada/U.S. investment and trade relations. In several respects, Canada/U.S. investment policy issues are linked to trade issues. First, Canadian investment policies in recent years have been designed to directly affect trade patterns, e.g., in the negotiation of local-content undertakings by investors. Second, policymakers in the United States increasingly view direct investment restrictions as burdens on U.S. trade, as foreign investment often facilitates home-country export and import activities. Third, there is growing attention toward 'trade in services' issues, which are, in a number of their aspects (e.g., the 'right of establishment'), closely related to investment issues. Thus, the future state of Canada/U.S. trade relations (e.g., in the evaluation of sectoral free-trade proposals) will depend upon the state of bilateral investment relations.

BACKGROUND: STATEMENTS OF INVESTMENT POLICIES

The governments of both Canada and the United States have recently issued statements on international economic policy relevant to the topic of this paper. In August, the Government of Canada issued two 'discussion papers' on its trade and investment policies; independently, less than two weeks later, the United States issued a new investment policy statement. These statements serve to clarify and highlight the nature of some of the major recent bilateral investment policy disagreements and some of the difficulties that could recur in the future. The Canadian discussion papers (Canada 1983a, b) extensively review the Canadian government's attitude toward foreign direct investment. In Canada (1983a) Canada's investment policy is presented as one of 'nonintervention in the investment process' (42). Exceptions cited to this rule include:

- the use of incentives to promote regional development, attract new industry, strengthen international competitiveness and stimulate structural adjustment;
- the Foreign Investment Review Act of 1973 and the National Energy Program of 1980, adopted to respond to Canadians' concerns about the large degree of foreign ownership of domestic assets; and
- the use of the 1973 Act as a way to screen foreign investments to ensure 'significant benefits' to Canada (42-3).

Concerning the past point, it is argued that foreign investment may be less desirable since multinationals may organize operations that 'may conflict with the attainment of national objectives' and that subsidiaries may be subject to home-country laws including export controls and antitrust laws (44). Thus, the purpose of the 1973 Act is made to both screen investments and to negotiate additional benefits for Canada.

In September, the White House released its 'International Investment Policy Statement', updating a similarly-directed document issued by the Carter Administration in 1977. It articulates the policy view the Reagan Administration has operated under since 1981. Like that of the previous Administration, the new statement reflects a traditional U.S. liberal attitude toward foreign investment; however, it also reflects a significant shift in emphasis from the previous statement. The Carter Administration indicated that its fundamental investment policy was 'neither to promote nor to discourage inward and outward investment flows'. It also stated that while the U.S. government should seek national treatment of firms once they are established, it should not 'intervene' with respect to any international investment activities of companies (National Advisory Council 1977). The underlying thesis of the 1977 statement became known as the 'investment neutrality doctrine', and has been criticized severely by most business groups which hold that U.S. investment overseas serves U.S. economic interests (Business Roundtable 1983).

The September 1983 statement, in contrast, articulates the Reagan Administration's view that international investment flows should generally be subject only to 'market forces', and that both home and host countries gain from investment flows that operate according to these forces. The United States is actively opposed to domestic and foreign government policies that 'impede or distort investment' or seek to 'shift artificially the benefits' of investment flows, including performance requirements, incentives and discriminatory treatment of foreign investors. The statement also commits the United States to work to reduce or eliminate 'unreasonable and discriminatory barriers to entry of investment' (White House 1983). Thus, the Reagan Administration intends to intervene in the international investment arena by seeking the removal of foreign direct investment obstacles.

The new U.S. statement also reflects the recent evolution of the United States as a major host country for foreign direct investment. Between 1970 and 1982, foreign direct investment in the United States increased from $13.3 billion to $101.8 billion (Whichard 1983). Between those years, inward direct investment grew by an average of 18.5 per cent a year compared to a growth of 9.4 per cent per annum in U.S. direct investment abroad.

U.S. policy toward inward direct investment is to provide 'fair, equitable and nondiscriminatory treatment'. The statement grants that U.S. foreign investment policy is not a completely laissez-faire policy, noting that limitations on inward investment flows exist where they are necessary to protect U.S. security and related interests, consistent with international legal obligations.

The premises underlying the U.S. position on foreign direct investment flows are: first, market-responsive direct investment flows to and from the United States increase the efficiency of the use of capital and technology, benefiting both the United States and foreign host and home countries; second, U.S. investment abroad enhances rather than destroys U.S. trade opportunities as well as foreign production through a greater U.S. business presence abroad and the positive macroeconomic effect such investment flows have on foreign incomes and overall imports; third, U.S. direct investment flows to developing countries can contribute to their development process and, thereby, to their political stability and U.S. political objectives.

Both the Canadian and American policy statements declare liberal policies toward inward flows of foreign direct investment. Nevertheless, these two statements represent quite different attitudes on foreign investment issues. Canadian policy reflects a continuing fundamental concern about foreign ownership and whether foreign investment generally provides 'significant benefits' to Canada. On the other hand, the U.S. policy view presumes that inward foreign direct investment is beneficial. Indeed, most of the U.S. policy attention is directed at problems of U.S. direct investment activity abroad. I have not heard Canadian policy officials express themselves on conditions affecting the treatment of Canadian investment in foreign countries (except with regard to the application of a worldwide-income-based 'unitary tax' system in some of the states of the United States). Despite Canada's growing direct investment position abroad (with net outward flows since 1974 – becoming quite substantial after 1977), Canada's overall investment policies reflect the viewpoint of a capital-importing country. Canadian policymakers express the view that (reflective of 'divergent national interests') U.S. and Canadian investment policies 'are likely to remain in conflict throughout the 1980s and beyond' (Canada 1983a, 208). Canada's Ambassador to Washington has elaborated on the basis of this presumed conflict in a recent address:

> Capital exporting countries which derive economic benefit from investment abroad *want* the freest possible international regime. Conversely, capital importing economies need to balance their need for capital with their *need* for a proper measure of national economic control (Gotlieb 1982, italics added).

Canada and the United States continue to maintain substantially different policy views on the role of government intervention generally, and in foreign direct investment flows (Malmgren and Drouin 1981-2). Of course, in the absence of multilateral or bilateral agreements on direct investment issues which would provide for a common set of objectives, policy differences on investment issues exist not only between the United States and Canada but also multilaterally, particularly between most OECD countries and the developing countries. Of greater importance, however, is how policy differences between our two countries are managed in the absence of a multilateral framework. Lacking such a framework, we have to look to bilateral processes. While the United States and Canada are members of the OECD which has codes relating to direct investment issues, the OECD does not provide a very satisfactory international framework because its enforcement mechanisms are very weak; further, Canada is not a signatory to one of the OECD's investment codes, the 1961 Capital Movements Code. It is the U.S. view that it is in the mutual interest of Canada and the United States to work together toward new agreements and forms of economic cooperation and liberalization in the investment area – not only in our bilateral relationship but also multilaterally. We also wish to see a better international understanding of how investment policies may have an impact on existing international agreements covering other activities, such as the GATT system of trade.

U.S. ATTITUDES TOWARDS THE INVESTMENT POLICIES OF CANADA

Canadians are sensitive to recent private and public U.S. views expressed on Canada's investment policies. It is frequently asserted that we in the U.S. government seem to be singling out Canada's investment policies for special attention and criticism, ignoring restrictions of other countries and demonstrating a lack of appreciation for the economic policies frequently adopted by Canada that are different than those preferred in the United States. Actually, we do not discriminate for or against Canada in urging the adoption abroad of fewer restrictions on direct investment flows; unlike Canada's recent policy statement, the U.S. investment nowhere contains an explicit or implicit reference to Canada/U.S. relations.

Underscoring the emphasis given by the United States to liberalizing foreign direct investment flows worldwide are the large number of bilateral agreements, in the form of treaties, that contain direct investment provisions. Typically, these treaties – formerly called friendship, commerce and navigation (FCN) treaties and, now, bilateral investment treaties (BITS) – provide that governments should accord national treatment to business activities including the organization and acquisition of companies by nationals and companies from the other country. (They also address the issues of expropriation and business transfers of funds.) The treaties, nevertheless, allow each country to reserve the right to restrict the activities of foreign nationals or companies in certain sectors by the United States or its partners. Normally, sectors that may be reserved are those which many countries consider to be politically or economically sensitive or related to national security concerns, including: common-carrier communications systems, air and water transport, banking, natural resources and the ownership of real estate. The actual restrictions in place may be only minimal, permitting significant foreign investment. In the United States, for example, there is substantial foreign direct investment in the banking, energy and real estate sectors. Moreover, these derogations from national treatment are tempered by a provision requiring that restrictions or discrimination put into effect by either country in these sectors shall *not* apply to foreign investments existing *before* the new measures are enacted (Sullivan 1980; USTR 1983b). Thus, exceptions to national treatment in these treaties are few, and investments are 'grandfathered' against new restrictions or discrimination policies implemented after investments are made.

Over the past decades, the United States has signed treaties of this type with most of the major OECD countries and with a number of developing countries, including Pakistan, Korea, Egypt, Panama, Taiwan and Thailand. In our agreements with developed countries, no general investment screening mechanisms are permitted. On the other hand, investment screening is not inconsistent with treaty provisions in some of our agreements with developing countries.

This discussion of bilateral investment treaties is intended to demonstrate that the position that the United States has presented to Canada has been one put forward to many other countries. In addition to bilateral treaties, the United States has also joined other OECD countries (including Canada) in the 1976 Declaration on International Investment and Multinational Enterprises. The Declaration provides that, allowing for the protection of national security, OECD countries should provide national treatment to foreign companies operating in their territories and owned by nationals of other member countries (OECD 1976). Unlike U.S. bilateral agreements with a number of developed countries, the 1976 Declaration allows generally for the screening of foreign investment by any country; once permitted, however, such investments are to be treated no less favourably than investments carried out by a country's nationals. New derogations from the national treatment Declaration (e.g., Canada's National Energy Program) are subject to multilateral review in the OECD Committee on Investment and Multinational Enterprises, but not to other penalties levied by other signatories.

While the United States approach to addressing investment restrictions is global, U.S. concerns about Canada's policies reflect the substantial trade and investment commitment the United States has in Canada.

CANADA'S FOREIGN INVESTMENT REVIEW ACT

Until 1973, both the United States and Canada pursued generally similar policies with respect to inward foreign direct investment. Neither country generally screened foreign investments unless such investments were proposed in certain sensitive or 'key sectors'. Some of the major sectoral restrictions in the United States were noted above. Limitations on foreign ownerships had existed in a number of the corresponding sectors in Canada – *viz.*, air, rail and water transport; broadcasting; insurance, banking and trust companies; securities firms; and certain mining activities on public lands (Franck 1976). A major additional step taken to respond to the political and economic arguments to limit the growth of foreign-owned or controlled investments in Canada was the enactment of the 1976 Foreign Investment Review (FIR) Act and the establishment of the Foreign Investment Review Agency (FIRA). The FIR Act requires the Canadian government to permit the foreign acquisition of Canadian enterprises or establishment of new businesses only if they individually result in 'significant benefit' to Canada. The significant-benefit criteria outlined in the Act for evaluating any foreign investment cover:

- the impact on economic variables such as employment, resource processing, exports and the use of Canadian 'parts, components and services';

- the degree of 'participation' by Canadians in the proposed enterprise and the industry in which the enterprise would operate;
- the effect on productivity and innovation and product variety in Canada;
- the effect on competition in Canada; and
- the compatibility of the proposal with national and provincial economic and industrial policy objectives (FIR Act 1973).

The FIR Act constitutes a substantially different approach to inward direct investment than U.S. policy. In addition to Canada's key-sector approach to restrictions (which is also applied in the United States), the Act imposes a general foreign screening process on acquisitions, new establishments and expansion into new business fields by foreign-controlled enterprises already operating in Canada. The Canadian government has stated that the FIR Act is a political response to excessive foreign ownership in Canada. Notwithstanding this, the government has also indicated that it is not the Act's purpose 'to discourage or prevent foreign investment', but to ensure beneficial foreign investment (Canada 1983a, *op. cit.*). Canadian officials have stated that Canada welcomes foreign investment, noting that over the life of the Act, only 10 per cent of the foreign investment applications have been rejected. And the rejection rate appears to have declined since mid-1982 when a change was made in the leadership of the Foreign Investment Review Agency and the Ministry of Industry, Trade and Commerce and new procedures were implemented designed to 'streamline' the review process.

Having a low rejection rate for foreign investment applications, of course, does not signify that the FIR Act has not had a negative effect on foreign investments. Many applications have been withdrawn and an unknown volume of investments have never been proposed because of the uncertainties involved in dealing with the Canadian government; or, in some cases, because of the perception that foreign investment proposals will be denied when, for example, they would introduce new competition for locally-owned firms.

It is widely known among foreign investors that there is complete discretion by the Canadian government in the application of the significant-benefits criteria mentioned above to a given investment proposal. The Canadian government has resisted clearly articulating how the criteria should be applied on an industry sector basis (Gray to

Fraser, 1982). There are no guidelines to understanding the relative significance that is to be attached to the criteria (*Businessman's Guide* n.d.).

Because of the cost and uncertainty of the FIRA process, many American businessmen believe that it is a substantial impediment to foreign investment in Canada (LeMay 1983). The trend of foreign direct investment flows to Canada since 1974 suggests that the FIR Act has had some impact on preventing foreign investment in Canada. Table 1 presents statistics on inward and outward foreign direct investment flows of Canada since 1960. Since 1974, Canada has been a net exporter of direct investment capital; further, it has experienced reduced inward direct investment flows since 1974 compared to the period 1960-73, even in nominal terms.

Table 2 indicates that the share of total U.S. direct investment abroad going to Canada has declined substantially since 1974. Table 3 shows that reinvested earnings of U.S. firms have accounted for practically all U.S. direct investment there since 1973. (Earnings reinvested by foreign affiliates in the same line of business activities are not reviewable under the FIR Act.) While other factors (including recent fluctuations in Canadian and worldwide economic growth, the National Energy Program and previous political uncertainties about the status of Quebec) may also have been important factors, it appears that the FIR Act has had a significant effect on flows of offshore direct investment funds to Canada. An opposite trend has occurred in the United States, with indirect investment flows increasing substantially in recent years (see Table 6 below).

The Canadian process of investment screening has been an important source of irritation to U.S. businessmen and government officials in the United States. Although it is conceded that Canada is violating no international rules by the screening of investments, it is viewed as a protectionist process in the trade, as well as investment contexts.

One of the Act's significant-benefits criteria is the effect that a foreign investment proposal has on competition within Canada. The beneficial impact of competition has been frequently cited as a factor in the acceptance of foreign investment proposals (Morici et al. 1982, 42). Nevertheless, the FIRA process invites the possibility that domestic Canadian firms may lobby the government to block a given foreign investment proposal. U.S. officials have heard American

TABLE 1

Average annual flows of foreign direct investment to and from Canada[a] 1960-1982 (C$ millions)

	(1) Foreign direct investment in Canada	(2) Canadian direct investment abroad	(3) (1) – (2)
1960-4	$ 457	$ 93	$ 364
1965-9	665	170	495
1970-4	824	505	320
1975-9	332	1,349	–1,017
1980-2	–1,675	3,417	–5,092

a Excludes reinvested earnings.

SOURCE: Statistics Canada – Quarterly estimates of the Canadian Balance of International Payments.

firms cite circumstances of this practice, but it is impossible to estimate the full extent to which Canada's foreign investment review system blocks foreign investments in order to protect local firms.

Recently, there have been circumstances in which U.S. firms in Canada have been the object of 'unfriendly' acquisitions, such as those in 1981 involving U.S. energy companies. U.S. companies have argued that a frequently-used business tactic to discourage such takeover attempts – *viz.*, a counter-acquisition proposal – is impossible when the acquiring company is Canadian. The existence of the FIRA as a factor preventing a counter-takeover proposal, at the time Canadian firms were bidding for Conoco and Cities Service in 1980 and 1981, fueled efforts in the Congress to pass legislation barring Canadian acquisitions of U.S. energy companies (*Fortune* 1981). However, these pressures eased as the burden of rising interest rates increased the cost of acquisition and the Canadian government, in order to defend the Canadian dollar, put pressure on Canadian banks to avoid making loans for such acquisitions. However, the acquisition issue remains a potentially serious problem so long as there is a possibility of future numerous Canadian takeover attempts. Of course, there is an argument, so far prevailing in the United States, that we should not in the least way object to Canadian acquisitions of U.S. companies; nevertheless, there is a strong feeling of frustration in the U.S. business community that sometimes leads to proposals for

TABLE 2
Net flows of U.S. foreign direct investment abroad[a] (1960-1982) ($ millions)

	Total	Canada	Canadian % of total
1960-4	$ 2,543	$ 758	29.81
1965-9	4,723	1,388	29.39
1970-4	8,397	1,922	22.89
1975-9	15,556	2,337	15.29
1980	27,720	3,750	13.53
1981	9,680	-761	-
1982	-3,008	-1,313	-

a Includes reinvested earnings
SOURCE: The data and calculations are derived from annual issues of the *Survey of Current Business* published every August by the U.S. Department of Commerce, Bureau of Economic Analysis.

reciprocal actions against Canadian and other countries' investment screening policies.

Another problem in Canada/U.S. relations concerning the FIR Act relates to acquisitions which concern Canada only through an existing subsidiary relationship. In 1975, the Dow Jones corporation acquired an American book publisher holding a Canadian subsidiary (Irwin-Dorsey). The Canadian government reviewed the Dow Jones acquisition of Irwin Dorsey and decided that the acquisition had no significant benefit for Canada and disallowed it. And in 1981, the government also disallowed the transfer of ownership of Stange Canada from its prior American food-processing parent to another American firm, McCormick and Company.

In these cases and in others, the responsible Canadian officials usually have offered no explanation for the transfer disallowances. More importantly, it disturbs the U.S. business community and government officials that the process of the FIRA reaches out to affect 'extraterritorial' transfers between two foreign companies. A legitimate reason (in the U.S. view) for a FIRA review in this circumstance would be to check for possible criminal records of the directors of the acquiring company. However, it appears that two other objectives have predominated: first, to 'Canadianize' by means of forced divestiture of the Canadian subsidiary; and, second, to take

TABLE 3
U.S. direct investment in Canada 1960-1982 (US$ millions)

	Total flows of direct investments[a]	Reinvested earnings	Reinvested earnings as % of total flows
1960-4	$ 758	$ 412	54.35
1965-9	1,388	731	52.67
1970-4	1,922	1,436	74.71
1975-9	2,337	2,212	94.65
1980	3,750	3,589	95.71
1981	–761	1,920	–
1982	–1,313	812	–

[a] Flows of direct investment equal to equity and intercompany accounts plus reinvested earnings.

SOURCE: U.S. Department of Commerce (1983) *Survey of Current Business*, various issues published in August of each year.

the opportunity to seek commitments from the acquiring company to offer new 'benefits' to Canada. A FIRA case concerning Gannett, an American newspaper publishing company, illustrates the second objective. Gannett's acquisition of Mediacom Industries of Toronto, obtained when Gannett acquired another American company, was approved by Canada only after a series of export, local purchase, technology and financial commitments were made by Gannett.

The Gannett case illustrates another issue important to the United States, i.e., the inconsistency of the commitments extracted from foreign companies by the Canadian government under the FIRA process with Canada's international obligations. The lack of confidence on the part of the Canadian government that foreign direct investment in Canada will bring significant benefits to Canada has already been noted; thus, 'understandings' by companies to carry out in Canada R&D expenditures, local sourcing, exporting and encouraging Canadian participation in ownership and management are heavily weighed in the FIRA approval process. In more than 2,600 foreign investment proposals approved under the FIRA process through early 1982, more than 60 per cent of the cases involved commitments to increased processing or use of Canadian goods and services, 5 per cent to Canadian participation, 37 per cent to increased exports and 21 per cent to technological development (Morici, et al. 1982; 42). The high incidence of local-sourcing commitments reflects an emphasis given by the Canadian government to the development of indigenous suppliers of manufactured parts and service operations and to affect the alleged tendency of foreign companies to import rather than develop local sources. The Canadian government has often used its 'bargaining power' to 'negotiate commitments' including those on research and development expenditures, local sourcing, exports and Canadian participation in management. The outcome of a FIRA review of a recent Apple Computer Company investment negotiation is reprinted below as an example of the use of its bargaining power government under the FIR Act to negotiate performance requirements.

> The Honourable Herb Gray, then Minister of Industry, Trade and Commerce, announced that on September 21, 1981 Apple Inc. of California made the following undertakings prior to receiving FIRA approval of its investment application:
>
> (1) to make all officers, except the Chairman of the Board and Secretary, and all management resident Canadians;
> (2) to limit appointments of nonresidents to one year or less;
> (3) to sell at least 80 per cent of its product through independent Canadian retailers (unless market conditions require the use of company personnel to make direct sales);
> (4) to perform in Canada at least 80 per cent of all repair and maintenance service for products manufactured by the applicant or the new business and sold in Canada;
> (5) to seek actively and recommend to customers Canadian sources of compatible peripherals and materials subject to availability in sufficient quantities;
> (6) to commence manufacturing in Canada, when sales justify establishment of a 'module' employing approximately 100 people (anticipated within three years), and to review RPT progress toward this goal with the Department of Industry, Trade and Commerce twice a year;
> (7) to implement vigorously an existing agreement providing for the use of telidon interface kits (TIKs) dedicating Apple and its subsidiaries to the creation of a world market for TIKs;

> (8) to seek actively and develop Canadian sources for Canadian-made goods if competitively available (specifically power supply units and semi-conductor memories). ("For such purposes, complete information will be provided to Canadian suppliers regarding future worldwide requirements of the applicant, industry prices, and technology which the applicant is not restricted from communicating by previous agreements with third parties and which, in the judgment of the applicant, is required by such suppliers.");
>
> (9) to establish a corporate purchasing task force with the specific mandate of identifying and developing Canadian sources of supply for Apple's worldwide requirements;
>
> (10) to recommend to its worldwide dealers Canadian-made peripheral equipment, provided such products are competitive in price, performance and availability;
>
> (11) to ensure that at the end of the first year Canadian value-added (CVA) will not be less than 38 per cent of the cost of goods sold in Canada, and thereafter to make best efforts to achieve the highest level of CVA in accordance with the schedule (not available because of FIRA's secrecy regulations) submitted to FIRA by the applicant;
>
> (12) to establish within one year a Canadian software research and development group; and
>
> (13) to make best efforts to initiate R&D projects related to hardware. (Morici et al. 1982, 43.)

The breadth of commitments that foreign investors make, as illustrated by the Apple example, is striking. It should be noted that some of the performance commitments made by Apple are 'best efforts' or are conditioned on the appropriate economic circumstances (i.e., in undertaking (8) 'to seek actively to develop Canadian sources for Canadian-made goods if competitively available'); however, under the follow-up procedures of the FIRA, Apple will be called upon to justify noncompliance even for best-efforts commitments in periodic governmental reviews of Apple's performance.

In other cases the FIRA review process has produced specific local content commitments which are not qualified by references to competitive or economic availability of domestic products. An example is Apple's commitment (11) to ensure a 38 per cent minimum Canadian value-added in its cost structure. In another case, a U.S. machine builder that established a business in Canada in 1982 committed itself 'to specify, to its Canadian subcontractors, that only Canadian steel, hydraulic and pneumatic devices and all other components be used' (FIRA, 7 May 1982). Also, a large U.S. retail toy chain committed 'to purchase merchandise manufactured in Canada equal to 55 per cent of the value of all merchandise purchases of the Canadian business, during the first two years of operations, increasing to 65 per cent of of the value of such purchases, during the third and succeeding years'. In making the announcement of this case, the government stated that the toy company will 'purchase significantly higher levels of Canadian-produced goods than does the Canadian toy retailing industry as a whole' (FIRA, 4 October 1982).

All segments of of the American economy – business, labour and government – consider the issue of foreign performance requirements as another serious trade and investment distorting practice (LICIT 1981; Senate Hearings 1981). The Business Roundtable, a prestigious group of U.S. corporate chairmen, recently issued a statement on foreign investment which concluded, *inter alia*, that:

> The proliferation of performance requirements is making it increasingly difficult for U.S. companies to structure their foreign and domestic operations so as to maximize the efficient use of resources. Left unchecked, the expansion of performance requirements may dissipate many of the economic benefits presently derived from foreign investment and could adversely affect the international competitiveness of U.S. companies. (Business Roundtable 1983, *op. cit.*)

The U.S. government is concerned that these practices are expressions of protectionist pressures, distort trade and investment flows, may violate international agreements, and may generate increased pressure to have the U.S. mirror such policies or even to directly retaliate – all responses that would generate a downward trend in world trade and investment flows.

Canada, of course, is not the only country that imposes such 'performance requirements'. A number of other countries also use requirements as a condition for approval of foreign investments or the granting of financial investment incentives. As Table 4 indicates, most of these countries are developing countries. For these countries, as for Canada, local content requirements are the most common form of investment performance requirement.

TABLE 4
Selected countries with significant occurrences of investment performance requirements

Country	Local content and exportation	Equity participation	Technology transfer	U.S. foreign direct investment position 1981 (U.S.$ millions)
Argentina	x	x		$2,735
Australia	x	x		8,779
Brazil	x	x	x	8,253
Canada	x	x	x	46,957
Colombia	x	x		1,178
Egypt	x	x		1,082
France	x		x	9,102
India	x	x	x	431
Indonesia	x	x		1,861
Malaysia	x	x	x	849
Mexico	x	x	x	6,962
Morocco	x	x		42
Nigeria		x		218
Saudi Arabia		x		580
South Korea	x	x		778
Spain	x	x		2,887
Taiwan	x			574
Turkey	x		x	210
Venezuela	x	x		2,175
				$95,653

SOURCES: LICIT 1981; Robinson 1983; U.S. Department of Commerce 1981; Conference Board 1983; USTR 1983

A special cause of concern about Canada's use of such practices is that it is the largest trade and investment partner of the United States and is one of the more important developed country members of the OECD and the GATT. Thus, Canada's policies could harm U.S. interests bilaterally and (by example to other countries) worldwide. Furthermore, we believe that certain types of Canada's performance commitment policy – i.e., local content and export requirements – violate international trade rules established under the GATT. Our concern about these measures (which some interest groups in the United States would like to see adopted for the domestic automobile industry) has been great enough for us to lodge a complaint about Canada's trade-related performance requirements in the GATT. There, in Geneva, a panel formed to adjudicate the dispute has made a recommendation to the Council of the GATT. That recommendation will be dealt with early in 1984.

U.S. government officials have heard various arguments put forward to justify the FIRA-based negotiation of performance commitments or undertakings from foreign investors. They range from too little R&D spending in Canada to too many imports; from the creation of operations in Canada that are not globally competitive to the lack of Canadian participation in management.

It is also sometimes argued that efforts by the United States to exercise extraterritorial jurisdiction over its companies abroad, in matters such as the Soviet pipeline project or policies toward Cuban trade, necessitate performance standards for U.S. investors in Canada. The type of performance standards sought in the FIRA review process do not, however, seem related to this understandable concern of Canada. It should also be noted that even Canadians criticize the 'undertakings' policy, arguing that assumptions in Ottawa about the behaviour of multinational enterprises in Canada are erroneous, and the assignment of deficiencies in the Canadian economy to their activities is misplaced (Wonnacott and Wonnacott 1980).

One argument against multinationals' operations in Canada is that they spend less on R&D in Canada than they do at home. This argument ignores that fact that R&D spending in Canada is low relative to GNP compared with levels in other OECD countries; indeed, it has not been demonstrated that foreign subsidiaries in Canada spend on R&D activities less than do Canadian-owned companies – indeed, they sometimes spend more (Ibid.). One significant factor accounting for the low R&D level in Canada is probably its compulsory-licensing law applicable to Canada's pharmaceutical industry. Canada's law gives no right of exclusive use to holders of pharmaceutical patents. This is a sector that normally makes very substantial R&D expenditures (Business International 1983). And the problem of trade competitiveness is probably related as much or more to trade barriers in Canada's foreign markets than to the trade patterns of foreign subsidiaries in Canada (Wonnacott and Wonnacott, ibid.).

It is also argued that multinationals in Canada import more than their domestic counterparts, contributing to a loss of Canada's trade competitiveness (Gray 1982; Statistics Canada 1981); however, multinationals also tend to export relatively more than do Canadian-owned companies (Rugman 1983).

Of course, negotiations between the government and investors under the FIRA have to be conditioned by market realities. Also, some of the publicly announced commitments address what the foreign investors may have done, more or less, anyway. Representatives of U.S. companies have told me that it is good corporate policy to try to carry out some of the local-sourcing and other activities sought by Canada in the FIRA process in most host countries in which they invest. Nevertheless, according to one Canadian businessman, the officials responsible for the FIRA's administration have in recent years been 'out for all they can get' in investor commitments (*Wall Street Journal* 25 Sept. 1981). As a result, the perceived costs and uncertainties for potential foreign investors have increased at a time when global recession reduced the overall confidence of investors worldwide. The plan to review retroactively the performance of all foreign firms operating in Canada, announced in 1980 (and then withdrawn late in 1981), at one time heightened uncertainties and criticisms abroad of Canada's policies. It also resulted in further pressure to react to U.S. business criticism of Canada's policies.

Since the end of 1982, however, there has been an apparent shift in attitude in Canada toward foreign investors. This shift is probably due to the economic costs of the substantial repatriation of foreign equity capital that took place after 1980 (see Table 1). Efforts have been made in Canada to reduce the procedural burden of the FIRA review process. American officials are hearing fewer complaints about the FIRA process in Canada. The improved FIRA implementation process in Canada reflects a growing worldwide trend toward the greater recognition that private direct investment flows are an essential element promoting economic development and adjustment in a rapidly changing world economy.

Occasionally, we still hear complaints from U.S. private interests about sought-after 'undertakings' or screening restrictions in Canada; the U.S. government is hopeful that we could work together to develop better bilateral understandings concerning this issue. Since, as we noted above, Canada does not hold a monopoly on the use of these measures, the U.S. Administration hopes that they could also be addressed in a multilateral context.

THE FUTURE OF PERFORMANCE REQUIREMENTS IN CANADA AND ELSEWHERE

As discussed above, the motivation for the use of performance requirements in Canada has been, according to Canadian authorities, to correct 'distortions' created by the decision-making process of multinational companies. This process, it is argued, tends to ignore local suppliers of components in favour of home-country suppliers or tends to export less overseas than do domestic companies. As noted earlier, the evidence concerning behavioural differences between foreign-owned and domestic companies in these and other economic respects (e.g., R&D spending) has received much attention in Canada; so far, the evidence is mixed, but it tends not to demonstrate significant and harmful consequences of foreign ownership for Canada (Statistics Canada 1981; Wonnacott and Wonnacott 1980; Rugman 1983).

On the other hand, local content and export requirements, to the extent that they significantly affect the purchase and sales decisions of firms, levy an additional cost burden on such firms. For example, a World Bank staff study showed that local content requirements in the automobile industry of some major developing countries increased costs of production by 60 to 200 per cent when local content requirements were placed at 60 per cent of production or more (Baranson 1969). Export requirements also impose domestic costs. These are either in the form of subsidy grants required to enable the producer to compete overseas, or, when there are no financial incentives, higher prices and returns in the local market necessary to make up for lower margins on exports (Balassa 1983).

Yet, if performance requirements increase costs or reduce returns, why do foreign firms sometimes find them to be tolerable? (In fact, some firms may actually defend them (MVMA 1982).) Larger countries have a relative advantage in imposing or negotiating local content, export or other types of performance requirements. Firms may be able to develop economies of scale sufficient to outweigh the costs of local requirements. However, unless there are natural barriers to imports into the domestic market (such as language or access to the local distribution system) the local government must offer either production or incentives to performance-requirement-burdened firms. In fact, substantial protection and incentives are frequent companion practices to trade-related performance requirements (Safarian 1983). Firms may seek protection or incentives in exchange for the imposition of requirements, or countries may offer them; in any case, it is countries like Canada, having large internal markets that have an edge in demanding local content and export commitments by firms in exchange for either. As seen in Table 5, for the automobile industry, in many developing or semideveloped countries protection can be quite high where performance requirements are present.

Even if tariff or nontariff protection is substantial in order to offset the costs of performance requirements, the disincentive effect associated with such measures may grow over time. Once in place, local content on export requirements may be tightened without corresponding increases in the level of final product protection. In Mexico, for example, local content requirements for some types of motor vehicles are being increased from 65 to 75 per cent. And in Taiwan, export requirements have recently been increased from 35 to 50 per cent of production. And, as mentioned earlier, the Canadian government at one time threatened to review the performance of even firms which had not been previously subject to FIRA review. There can be considerable uncertainty about the business environment in the presence of performance requirements, with a bias toward expecting that host governments will increase such requirements in the future. The local beneficiaries of content protection (i.e., domestic suppliers to final assemblers) and export requirements (domestic competitors of potential new foreign entrants) are natural political constituencies accounting for such a bias. The current worldwide recession and LDC debt problems are important reinforcements to this bias.

In the future, we can expect that protectionist pressures will continue to encourage the application of local content and export requirements; however, as the economic costs of such requirements, both in terms of higher final production costs and the discouragement of inward investment flows become better appreciated, one might hope that their use would gradually decline. A concern about the inadequate levels of domestic and foreign investment in many capital-

TABLE 5

Local content requirements for passenger cars in selected countries as a percentage of final value

Country	U.S. direct investment abroad in transportation equipment manufacturing[d] (1981 U.S.$ millions)	Required local content	Ad valorem import tariff	1981 production (000)	Export requirement
Argentina	$409	88%	55%	140	Yes
Australia	449	85	35-58	343	Yes
Brazil	679	95	182-205	621	Yes
Chile	(D)	30	20-60	21	No
Colombia	(D)	33	180	36	Yes
Egypt	*c*	15-40	85-200	17	No
Greece	0	25	10-21	5	Yes
India	7	*a*	*a*	42	No
Malaysia	2	18	60-100	86	No
Mexico	750	50-75	100	355	Yes
Morocco	N/A	40-50	57-97	14	No
Nigeria	N/A	30-100	33-200	85	No
Peru	(D)	30	66	22	No
Philippines	8	63	30-100	25	Yes
Portugal	(D)	22	*b*	61	No
S. Africa	(D)	66	20-100	301	No
S. Korea	(D)	20-95	100-150	67	No
Spain	(D)	55	68	855	Yes
Taiwan	38	70	65-75	86	No
Thailand	*c*	35	150	27	No
Venezuela	(D)	53	120	83	Yes

a import license for passenger car imports rarely issued. Companies are nationally owned and are encouraged to source nearly 100 per cent of their inputs.

b Specific duty.

c less than $500,000 (±).

d U.S. direct investment position in transportation equipment manufacturing includes motor vehicles and equipment manufacturing and other transportation equipment manufacturing (including aircraft, ships, railroad equipment, motorcycles and bicycles, guided missiles, travel trailers and campers, tanks, all terrain vehicles and snowmobiles). However, in 1981, U.S. direct investment abroad in motor vehicles and equipment manufacturing accounted for 95 per cent of the total U.S. investment in the transportation equipment manufacturing category.

(D) Data suppressed to avoid disclosure of data of individual companies.

N/A Not available.

SOURCE: U.S. Department of Commerce.

importing countries may accelerate this decline. Unfortunately, in the absence of a multilateral consensus or unilateral action by a major country against the use of such measures, there will exist, for some time, the tendency toward experimentation with the use of performance requirements as a response to the current period of worldwide slow growth and painful economic adjustment.

THE NATIONAL ENERGY PROGRAM (NEP)

Canada's 1980 plan to broaden the scope of the FIR Act to cover the review of the performance of existing foreign firms was followed later that year by the announcement of the details of Canada's National Energy Program (NEP).

The basic objectives of the NEP are to enhance Canada's energy security, increase the share of the petroleum and gas sector held by the Canadian government, and to achieve 'Canadianization' of the energy sector (with a goal of 50 per cent Canadian ownership) by 1990. U.S. objectives to the NEP have been largely directed at Canada's methods adopted to accomplish the last objective. The major U.S. objections include:

1 The introduction of a system of incentives for oil and natural gas exploration based upon the degree of Canadian ownership and control of the exploration company. Under the Petroleum Incentives Program (PIP) up to 80 per cent of exploration expenditures can be paid to companies with 65 per cent Canadian ownership, with the ownership requirements varying up to 75 per cent by 1986. (Foreign-owned and controlled corporations are eligible for grants covering 25 per cent of expenses.) Notwithstanding Canadian concerns about the degree of foreign control of its domestic energy industry (59 per cent of assets in 1980), the discriminating policy runs counter to the 1976 OECD Declaration that obliges member countries to provide national treatment to foreign enterprises 'operating in their territories'. Exceptions to this obligation are permitted to maintain public order or to meet national security or international peace commitments; however, placing foreign firms at a competitive disadvantage is not sanctioned for the purpose of 'localization' of existing companies.

2 The claim to a 25 per cent 'Crown share' of exploration and production leased rights held on federal lands, applied retroactively

and without adequate compensation. Limited *ex gratia* payments were authorized by Canadian legislation to compensate for the cost of drilling wells that lead to significant discoveries of oil or gas; but the Canadian government has indicated that the payments are not intended to represent compensation for the Crown share. The 'Crown-share' policy does not discriminate against foreign-owned companies . Both Canadian and foreign-owned companies have claimed that the *ex gratia* payments do not cover either the value of the share taken by the government or the costs incurred in the past in drilling wells that did not yield oil or gas. Estimates exist that the payments represent less than 5 per cent of the value of the Crown interest taken on the major federally-owned oil fields (Canadian Senate Debates, December 15, 1981).

3 COGLA administration: pressures on Canadian government-owned oil and gas lands to purchase domestic goods and services. While the Canadian government contends that its policy is designed 'only' to encourage open bidding and Canadian opportunities to sell to large energy projects, the administrators of this policy appear to force companies to justify use of imported items.

These NEP measures, coupled with a 50 per cent Canadian-ownership requirement for future leases on Canada federal lands, led to demands from segments of the U.S., European and private sector for 'reciprocal' denial of access to U.S. federal minerals leases under the Mineral Lands Leasing Act of 1920. However, the U.S. government determined in early 1982 that Canada was reciprocal under the meaning of that Act. This determination was made on both legal and investment policy grounds. To deny Canadians energy investment opportunities in the United States would have slowed the rapid movement of drilling rigs from Canada to the United States in 1980 and 1981. Canada's energy policy, ostensibly designed to enhance its energy security, actually has contributed to U.S. energy development and production.

Notwithstanding the U.S. government's decision to declare Canada reciprocal under the MLLA, the decision in no way reflected a modification of the U.S. government's critical attitude toward certain aspects of the NEP and FIRA (which is used to implement the NEP's policy on 50 per cent Canadian ownership of corporations operating on

Canada lands). The U.S. Interior Department, responsible for administration of the MLLA, noted in its press release of February 3, 1982, that

> Secretary Watt's determination was based strictly on an interpretation of the reciprocity provision of the MLA. . . . [However] the Administration continues to be seriously disturbed by Canada's discriminatory investment policies, embodied in the National Energy Program and in the operations of the Foreign Investment Review Agency (FIRA). (U.S. - Interior 1982)

The reaction in 1981 in the United States to the FIRA and NEP included proposals from various quarters to: retaliate in kind against the actions taken by Canada, tighten U.S. securities laws, block Canadian investment in U.S. energy companies, and enact an American version of the FIRA. They also fueled the calls for reciprocity legislation now being considered by the U.S. congress. Some of the proposals would have changed basic U.S. policy toward inward foreign direct investment.

UNITED STATES INVESTMENT POLICY

The negative U.S. reaction to Canada's FIRA and NEP flowed from a traditional U.S. viewpoint on investment policy, reflected in the recent investment policy statement of the Administration. The United States has been dedicated to working toward the reduction of barriers to foreign direct investment flows, the strengthening of the principle of national treatment and maintaining an international commitment to prompt and adequate compensation in the event of expropriation. But it has seen the largest trade and investment partner tightening conditions placed on foreign investment in recent years; it sees, in the NEP, new discrimination against existing foreign investors, contrary to obligations entered into in the OECD; it also sees a failure to compensate investors, foreign as well as domestic, for a governmental taking of property through the Crown-share (or back-in) provision of the NEP; finally, it sees, in the use of investment performance requirements, an attempt to augment artificially the benefits to Canada's production and trade.

Canadians have countered U.S. criticism of Canada's investment and related energy policies. They have argued that the United States has as many barriers, or more, to foreign investment as does Canada (FIRA 1982; Regan 1982; Patterson 1983). Former Minister of State for International Trade Gerald Regan has argued:

> The diffuse approach of most other industrial countries compared with the more comprehensive administrative system in Canada reflects a distinction more of form than of substance with little difference in the impact or restrictive effect upon incoming foreign direct investment. For example, while the U.S. is relatively open in terms of foreign investment, there are a number of sectors where foreign control is prohibited or regulated....Apart from outright prohibitions, the U.S. also has indirect controls on foreign investment including anti-trust laws, congressional lobbying, and monitoring bodies such as the Committee on Foreign Investment. (Regan 1982)

The author has noted above and elsewhere those major sectors in which the United States maintains at least nominal special conditions or restrictions on foreign investment (Bale 1983). With regard to lobbying of the Congress, this is an area that is fair game open to everyone, including Canadians and their local Washington representatives (both private and official); but, I know of no recent significant cases of lobbying being effective in getting Congress to act to intervene effectively in proposed foreign investments, either acquisitions or new plants. Regarding acquisitions, the United States is the only major country with a permissive policy toward 'unfriendly takeovers', regardless of the parties involved.

Frankly, I am puzzled by the assertion of the importance of the effect of U.S. antitrust laws on foreign investment in the United States. I know that they are sometimes cited as a barrier to such investment. However, as Canadians will be first to agree, no society grants an unqualified 'right of establishment' to enterprises, foreign or domestic. The U.S. issue regarding foreign investment is whether there is international discrimination, or lack of national treatment. In this respect we believe that U.S. antitrust laws are no more a burden on foreign enterprises than they are on domestic ones. It may have been true that antitrust enforcement authorities were excessively hostile at various times in the past to acquisitions and mergers generally, leading to a view among some observers that U.S. antitrust policy and, specifically, the doctrine of 'potential competition' was a tool to bar foreign investment in the United States. Recent court cases and the development of new antitrust guidelines by the U.S. Justice Department, however, strongly suggest 'far less enthusiasm for the potential competition doctrine' (Floyd 1983).

Finally, there is the reference in the above quotation of Minister Regan to the Committee on Foreign Investment in the United States (CFIUS). I have discussed this Committee more fully elsewhere (Bale, *op. cit.*). American officials are bemused in hearing comparisons made between the FIRA process and the CFIUS. Two key points to be made about CFIUS are (1) its objective in recent years has been almost exclusively to look at how the national interest is affected by investments in the United States by government-owned foreign enterprises (e.g., BP, Elf-Aquitaine, CDC, Kuwait Petroleum Company); and (2) it is the product of an Executive Order, having no vested authority itself to bar any foreign investments. It exists basically as an advisory body to the President and the various executive departments; while some consideration has been given recently to vesting certain authority in the CFIUS to deal with investments by government-owned enterprises, a specific plan of action has not been developed. Many are fearful in our country that giving any government body any authority to screen investments might lead eventually to the enactment of a U.S. FIR Act. It is probable that the states would lobby very hard to prevent federal-level intervention in foreign investment activities which have benefited many states.

If, indeed, U.S. investment policy were as restrictive as some Canadians claim, one would be totally confounded as to why and how foreign investors have been so plentifully and successfully investing in the United States in recent years, compared to their activities in most other countries. Tables 6 and 7 show, respectively, the growing importance of the United States as a host country to foreign investment, both in absolute terms (Table 6) and relative to other OECD countries (Table 7). Many foreign investors view the United States as a very tough and competitive market to enter. Nevertheless, even in sectors of insurance, banking, real estate and mining where some states have laws that place some conditions or limits on foreign

TABLE 6

Total flows of U.S. foreign direct investment 1960-1982 (U.S.$ millions)

	(1) U.S. direct investment abroad[a]	(2) Foreign direct investment in the U.S.[a]	(3) Net (2) – (1)
1960	$ 2,940	$ 315	$ –2,625
1965	5,011	415	–4,596
1970	7,590	1,464	–6,126
1971	7,618	367	–7,251
1972	7,747	949	–6,798
1973	11,353	2,800	–8,553
1974	9,052	4,760	–4,292
1975	14,244	2,603	–11,641
1976	11,949	4,347	–7,602
1977	11,890	3,728	–8,162
1978	16,056	7,897	–8,159
1979	25,222	11,877	–13,345
1980	19,238	13,666	–5,572
1981	9,680	21,998	12,318
1982	–3,008	10,390	13,398

a Includes reinvested earnings

SOURCE: *Survey of Current Business* U.S. Department of Commerce.

investment, the presence of foreign investors in the United States is great and rapidly growing. For example, six of the ten largest banks in California are foreign-owned and 40 per cent of the banking business in New York State is controlled by foreign-owned banks (Fry 1983). Further, Canada and other foreign interests have invested heavily in U.S. real estate holdings.

While not yet reaching the same proportions in Canada, foreign investment is becoming a significant element in the U.S. economy. In 1980, foreign direct investors controlled 9 per cent of total U.S. assets in the U.S. mining, manufacturing, petroleum and trade sectors. Foreign control was 15 per cent of U.S. assets in wholesale trade, 7 per cent in manufacturing, 18 per cent in chemicals, 13 per cent in stone, clay and glass and 9 per cent in electronic equipment. In addition, foreigners controlled $44.1 billion in U.S. petroleum and coal industry assets (Belli 1983). Indeed, it is the world business community that

TABLE 7

Inward direct investment flows: percentage distribution among 13 OECD countries

Country	1961-7	1968-73	1974-8
Canada	16.2	12.1	3.2
United States	2.6	11.4	26.7
Japan	2.0	1.7	1.2
Australia	15.6	12.9	9.5[a]
Belgium	4.5[b]	6.1	9.4
France	8.2	8.2	15.2
Germany	21.3	16.4	14.7
Italy	11.5	8.3	5.0
Netherlands	4.7	8.5	6.0
Sweden	2.4	1.7	0.5[c]
United Kingdom	9.7	7.4	6.1
Spain	2.7	3.7	3.7
Norway	0.8	1.4	4.1

a From 1974 to 1976

b From 1965

c From 1974 to 1977

SOURCE: OECD (1981) *International Investment and Multinational Enterprises: Recent International Direct Investment Trends* (Paris) 41.

has provided the primary evidence on the issue of relative absence of investment restrictions in the United States. They have made their evaluation in real financial terms, using their Canadian dollars, pounds, yen, francs and marks for direct investments in the United States, which reached a level of over $100 billion last year.

Nevertheless, U.S. policymakers at the federal and state level cannot remain complacent. Inward foreign direct investment is becoming a welcome source of much needed capital to assist the United States in its adjustment to changing world competitive conditions, and we need to be attentive to developments that may dampen the future growth in the level of inward direct capital flows. For example, fourteen states have in place some form of a 'unitary tax' which uses a tax formula that extends to variables beyond the state tax area to cover worldwide operations. While the tax is applied equally to both U.S. and foreign-owned companies, its impact tends to be greater on foreign companies. Any spread of this type of tax system to other states could have a major negative effect on the investment climate in the United States. In addition, the example of the U.S. use of unitary taxation could invite other national jurisdictions to follow a similar policy that would affect the investments abroad and the returns from them to American shareholders.

CONCLUSIONS

Investment issues will probably continue to remain a sensitive area of bilateral Canada/U.S. relations. There is a fundamental difference between the two countries in the role that government plays in the national and local economies (Malmgren/Drouin, *op. cit.*). This, plus the relatively high degree of foreign ownership in Canada, means that the two countries will see foreign direct investment policy from different perspectives.

Nevertheless, investment issues need not be important negative elements in our bilateral relations. Canada has also become a net exporter of direct investment and capital. Both countries increasingly recognize the costs of policy conflict and and the benefits of cooperation. Complaints by American businessmen about the FIRA have recently receded. In the trade field, consideration is being given in Canada to the development of proposals for bilateral trade agreements on a sectoral basis.

Both Canada and the United States have experienced the adverse impact of the global recession, the attendant liquidity crisis in the LDCs, the new competition coming from developing countries and the threat of protectionism. If we are to adjust to these forces and get back on a path of sustained noninflationary economic growth, we will need to accomplish, at the minimum, two tasks. First, we will have to maintain an open system of trade. Sectoral or other forms of trade liberalization may be able to contribute to the momentum necessary to maintain progress toward greater trade liberalization. Second, we need to ensure the growth of both domestic and foreign investment. Foreign investment is an important supplemental source of capital and technology for both of our countries. It is vital to the adjustment of our economies to the challenges of the intensified global trade competition. Thus, just as there is a need for bilateral and multilateral cooperation in the field of trade, so is there a similar need to establish a positive cooperative relationship among countries in the investment area. I am increasingly optimistic that the respective publics and governments will (at least by the sad lessons of experience, if not foresight) appreciate the gains to be made and will work together accordingly.

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Comments

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As I have heard and read about various investment performance requirements, particularly those used in Canada, I have been intrigued by the implicit acceptance of the views, apparently held by the governments involved, that such requirements are beneficial to the host country and harmful to the home country from which the investments originate. Both of these effects may in fact be valid, but it surprises me to see so little discussion of how these requirements affect the countries involved. As I have thought about it, it is not at all obvious that such policies are inappropriate from a global point of view; nor is it clear why they should be expected to help the country in which the investment takes place. As always for problems of this kind, the benefits and costs of the policies depend on the context in which they are used, as well as, in this case, on the particular form that the policies take. In my discussion, I will touch on several situations in which investment performance requirements may make sense, and some other situations in which they apparently do not. None of this is conclusive, of course, but I hope it will direct the discussion towards finding out what is being accomplished by these requirements, so that ultimately we will be able to understand whether they really are the nefarious acts that they are so often made out to be.

That the issue may not be clear-cut should not be surprising, based on what we know from the theory of international trade. On the one hand, we know that any interference in free markets – and a performance requirement is certainly such an interference – in its own right constitutes a distortion and lowers welfare somewhere, either at home or abroad or both. On the other hand, we know that if other distortions are already present – and they inevitably are – then an additional distortion may be beneficial to all. Thus, in the theory of the second best, we are led to look for *reasons* for using a policy that distorts the market, these reasons being other distortions that the new policy may be able partially to undo. The lesson is not that anything goes; second best arguments for market intervention require that the distortions be quantified and the policies be calibrated carefully to avoid making matters even worse. Rather, the lesson is that one cannot justly condemn any policy on the basis of its own effects alone. One must look instead at the specific problem that the policy is intended to help solve, and evaluate it in that context.

As a first example, consider the effects of a local content requirement applied to an inflow of investment from abroad. Such a requirement certainly does distort the input choices of investing firms (or, at the very least, distorts the selection among potential investors in favor of those who would rely heavily on domestic inputs anyway). Were such a policy used in a context of otherwise perfectly free trade and capital movements, it would surely reduce welfare, at home if not abroad.

But suppose that the context is not one of free trade, but rather of protection. Suppose in particular that for whatever reason there are tariffs on final goods, but not on raw materials, intermediate goods, or semi-processed goods. If capital is at all free to move internationally, then it will seek to bypass the tariff on final goods by setting up minimal plants for final processing behind the tariff wall. As a result, there will be an inflow of foreign investment, but the input choices of the investing firms will be distorted by the tariff against the use of domestic inputs. In this situation it may be that a local content requirement may serve primarily to correct the distortion of input choices caused by the tariff, and thus have largely beneficial effects.

Admittedly, this argument is somewhat suspect, since the choice of least cost inputs by the firms, wherever they are located, is not on the face of it distorted by a tariff on what they produce. And in addition we have the usual caveat that the first best policy action would be to remove the tariff itself. But suppose that we accept that there is in turn some valid reason for the tariff. Perhaps it is itself a second best policy for raising the domestic price in an industry to offset some other distortion. Perhaps it is the only politically acceptable way of pacifying the firms in a domestic industry that is threatened by import competition. Or perhaps it is being used on optimal-tariff grounds as a way of improving the terms of trade.

In any of these cases and others, an inflow of foreign investment that brings in only a small final stage of production or processing and leaves most value added taking place abroad, serves to undermine to a large extent the intent of the tariff, whatever it was. If enough firms move in to replace imports, then the tariff becomes redundant, and the domestic price in the industry rises by only the small amount of the increased cost of the domestic value added. The new subsidiaries provide just as much of a threat to previously existing domestic firms as did the imports, and they offset this threat only slightly for workers in the industry by providing a small amount of employment. As for the terms of trade, the country as a whole now pays somewhat *more* for the goods in question, since their price goes up by the increased cost of domestic value added, and none of this returns to the domestic government as tariff revenue.

Most of these adverse effects of foreign investment – adverse, that is, in terms of what the tariff was trying to achieve – can be removed by a local content requirement. The more value-added must be installed domestically, the more the price in the industry will remain near the level set by the tariff, the less will domestic competitors be undercut, and the more jobs will be available in any case in the foreign-owned firms and their domestic suppliers. Only the terms-of-trade effects continue to be adverse, since the real cost of the goods to the country is raised even more. Thus, by and large it seems that one can make a case for a local content requirement as a supplement to a tariff for many of the situations in which the tariff itself might be viewed as legitimate.

There is another example that I find quite interesting in which a strong case can be made for an investment performance requirement of a particular sort. This arises when the investment itself is subsidized and there is a second best argument in which the requirement offsets the distorting effect of the subsidy. Note first, though, that I do not mean to suggest the use of investment performance requirements as a way to offset completely the subsidizing effect of a subsidy. It is certainly true that any of these requirements, if sufficiently onerous, could wipe out any advantage provided to foreign investment by a subsidy and might stem the flow of investment completely. I take it though that this would not be done, at least intentionally, since one might then just as well omit the subsidy in the first place. Thus what I intend is to identify an additional distorting effect of a subsidy, one that extends beyond its obvious effect as a stimulus to investment, and argue that some form of investment performance requirement might offset this secondary and presumably unintended distortion.

Suppose then that a valid reason exists for providing an incentive for industry to move into the host country. Many such reasons are possible, but for concreteness suppose that uncertainties about the domestic markets and political environment make foreign investors more wary of locating plants in the domestic market than the host country government knows to be warranted. Here a subsidy to locating in the country is appropriate. Unfortunately, a subsidy to location *per se* is probably impossible, since it fails to distinguish among investors on the basis of their size. Thus, a more likely tool is a subsidy to investment – a subsidy, that is, that is geared to the cost of the capital that is installed within the country. An obvious example of this would be a subsidized loan to the firm making the investment.

The trouble with a capital subsidy, though, is that in addition to influencing location of production in the desired direction, it also distorts the choice of factor proportions between capital and labour. Unless no such choice is possible, unless, that is, production requires the use of capital and labour in immutably fixed proportions, an investment subsidy will cause investing firms to select more capital intensive techniques of production than would minimize costs if they were paying the true cost of capital. There is a loss of efficiency as a result that is borne by the host country. But it shows up even more clearly in the host country labour market, where the inflow of investment fails to provide as much of a stimulus to employment as it ought to.

In this situation one might recommend an additional subsidy to the use of labour, to match the one that applies to capital. But while an investment subsidy can conveniently be made in the politically expedient form of a once-and-for-all payment or a subsidized loan, a subsidy to labor seems to require an ongoing program of wage supplements that are unlikely to be acceptable. Therefore as an alternative policy one might consider the use of an investment performance requirement that mandates the use of particular amounts of labour per unit of capacity. If this required ratio of labour to capital is selected correctly as representing the least cost combination of inputs at undistorted factor prices, then the effect of this requirement is to restore the optimal input choice without altogether undermining the subsidy. Note that while the investing firm will find itself forced to employ a more expensive combination of factors than it would like, given the low cost it is paying for capital, it still is enjoying lower costs than would have been the case without the subsidy, and the subsidy is still effective. Thus this particular form of investment performance requirement – a labour content requirement in this case – can be justified as offsetting an undesirable distorting effect of an investment subsidy without undermining the stimulus to foreign investment that the subsidy presumably is intended to achieve.

These two examples of second best arguments for investment performance requirements do not extend, as far as I can see, to one of the more familiar forms of these requirements, the export requirement. I have given some thought to this issue, trying to find some rationale for the use of export requirements within the framework of conventional models of international trade, and I have not been notably successful. Let me tell you what I found, even though, as you will see, my thinking on this issue has mainly left me dissatisfied with the models themselves.

First of all, without some distortions in the economy, an export requirement would seem to have no effect at all. The reason is that, with free trade it really does not matter whether an individual seller sells on the domestic market or on the foreign market; goods will find their way through the markets in any case to the same demanders. For example, if foreign investors into what is already the export industry are required to export, they will only do what they or some other firm would have done anyway. If, on the other hand, the requirement applies to investors in an import-competing industry, one will find the seemingly perverse result of exports in that industry arising. But with free trade, these will simply be matched by greater imports of the same goods and the net flow of trade will be unaltered. Thus without some distortions, or at least some impediments to trade, export requirements are effectively meaningless.

I have tried looking therefore at models in which trade impediments do exist and in which export requirements can play some role. These are not hard to find. Consider, for example, a model in which capital and land are specific to two industries with labour mobile between them. Capital is used in the import-competing sector and, by means of a tariff, has its rate of return raised above what it would otherwise be – above, let us say, that which prevails abroad. If capital can move internationally, it will flow into this country, depressing the return to capital and raising both the wage and the return to land. If for some reason one wanted to prevent this from happening, an export requirement would indeed do the job.

If foreign investors were required to sell some fraction, say half, of the product as exports, they would not be able to achieve the same high rate of return as their domestic competitors. In essence, they would be selling for an average price half way between the high tariff-inclusive price on the domestic market and the lower world price. Thus their inflow of capital would stop short of depressing the rate of return to domestic capital all the way to the world level.

The trouble with this argument, it seems to me, is not that it would not work, but that it is not necessary. If one wants to prevent domestic capital from having to compete on equal terms with foreign capital, one does not need to provide a handicap to the operations of foreign capital. One could simply exclude it altogether. As far as I can see, an export requirement in this model is exactly equivalent, in terms of its effects on factor prices and factor allocations, to a simpler tax or quantitative restriction on the inflow of capital itself. Since the latter would also avoid the artificial and presumably expensive need to export and import the same commodity, I would think it should be preferred. Thus I cannot find, in this sort of a model, a plausible explanation for export requirements.

I thought for a while that a rationale for export requirements might be found by looking at departures from perfect competition. There have been many recent contributions to the literature of international trade theory that have focused on various noncompetitive models, and many of these have found novel arguments for uses of trade policy in ways that we normally condemn. Therefore, I thought, and in a sense I still believe, that imperfect competition would provide a suitably mixed up environment to make export requirements appear as rational policy.

Consider, for example, a situation in which a good is available only from a foreign monopolist which must, because of transport costs, invest in the domestic market in order to make it available domestically. The technology involves decreasing costs, up to a point, however, and the domestic market is not large enough to support a minimally efficient plant. My thought was that, by requiring the firm to export part of what if produces domestically, you could force it to expand production and thus lower costs and prices charged on the domestic market. I still think this is an intriguing idea, but unfortunately it does not work. As I have analyzed the problem, I find that the export requirement always leads to a higher price on the domestic market. The reason is that the cost of exporting at a loss (it has to be at a loss or the requirement would be satisfied voluntarily) must be figured into the cost of increasing sales on the domestic market. It turns out that this cost increase always more than matches any cost saving that can be achieved by increasing scale.

Another possibility that was suggested in this analysis was that an export requirement might help to erode the monopoly power of the foreign firm. If demand on the world market is more elastic than at home, then by requiring that domestic sales be matched in some proportion by exports one might increase the effective elasticity of demand facing the foreign firm in its decision as to how much to sell domestically. This increased elasticity, as is well known, should reduce the markup of the monopolist and permit an expansion of sales. Unfortunately, this argument too seems to fail when I try to draw it out of a simple model. Again, the increased cost of selling exports at a loss apparently outweighs any benefit from a reduced markup.

I have not given up completely on the possibility that imperfect competition might provide a role for an export requirement. My first argument might work if the export requirement were not pegged to domestic sales, but instead set at a fixed quantity per plant. And the second argument might be salvaged if the export requirement were combined with some sort of subsidy. But in either case I would suspect that the basic inefficiency of requiring exports from an industry in which there is not a comparative advantage will assure that any small gain that might be achieved could be surpassed by some other more direct and simpler policy. A direct tax on the profits of the monopolist, if these profits can be identified, for example, or a tax on pricing the product above some minimum level, would both be likely to be socially preferable policies.

Having said all this, I would like to conclude by admitting my own sense of dissatisfaction with what I have said. I feel that I may have missed the point. I have been looking for reasons for investment performance requirements within models of trade that may already have abstracted from what the true reasons really are. This is not the first time I have felt this, but I feel it especially strongly here.

Intuitively, it seems clear that export requirements – and to a lesser extent the other performance requirements that so many countries use – are intended quite simply as a way of acquiring foreign exchange. Why does a country want foreign exchange? In order to be able to import. Trade theory typically does not speak of foreign exchange, but does certainly acknowledge the fact that a country cannot import if it does not export. In fact, without foreign exchange and financial assets generally, the constraint of the trade balance is totally binding. Nonetheless, we do not normally model exports as imposing a binding constraint on imports. The reason is that, for small countries like Canada especially, we expect traders to be price takers in both the markets for imports and for exports, able to buy and sell all they desire at given world prices. The constraint on imports is not what a country *can* export but what it *wants to* export. As such, no artificial increase in the amount of exports can increase welfare.

The trouble is, it seems to me, that countries *do* face constraints on exports, at least in many of the world markets in which they participate. Particularly in manufactured goods, countries, like the individuals and firms within them, would like to sell more if they could; they just can't. The skills in marketing their products that are so important for many firms are also important for the countries from which they operate, since their ability to sell abroad and acquire foreign exchange limits the ability of the country as a whole to import and thus gain from trade. Conventional trade theory and even most of the more modern work on imperfect competition and international trade do not allow for the possibility that many markets exist quite naturally in a chronic state of excess supply. Most sellers in the market would sell more if they could, and they devote a good deal of time and resources to trying to accomplish this. Without a view of the trading world that acknowledges this, I doubt that we can ever make very useful sense of such practices as export requirements applied to foreign investment.

If a country's imports are constrained by her exports, and these are in turn constrained not by domestic supply but by foreign demand, then it makes sense to seek the help of successful foreign corporations that have already acquired a share of world markets. Indeed, an exchange of markets is likely to be possible, since the corporations, in spite of their success, are also fundamentally constrained by the demands they face. Thus, it may be both possible and desirable for a country to exchange access to its domestic market for the corporation's assistance in penetrating markets abroad. The simplest way to do this may be by attaching an export requirement to any permit to invest in the domestic market.

I have no idea whether this sort of an argument can be made rigorous, since it goes well beyond the scope of economic theory as I know it. Unless and until it is, I would not want to accept it as anything more than the most tentative of suggestions. Still I believe that something like this argument has to be considered if we are to understand and evaluate the policies we see being implemented in the real world.

Comments

Robert G. Logan
IBM Canada Ltd.

It is a pleasure to be here this afternoon to share with you my views concerning Canada/U.S. investment frictions.

Working for a large American multinational in Canada provides me with a unique view of this contentious bilateral issue. Furthermore, because we are moving increasingly into an information society and IBM is a dominant figure in the information technology industry, I believe it also provides me with an added perspective on some future prospects for this issue.

There is little doubt that I fundamentally support the position taken by Harvey Bale in the paper he presented today. Perhaps the point I am most in agreement with is the change he made in the title from *U.S./Canadian Investment Frictions* to *Investment Frictions and Opportunities in Bilateral Trade Relations*.

Indeed, I believe there are many opportunities developing in both countries as our respective economies move increasingly towards what some have called the Information Age. Given a world share where interdependencies and international competition will dramatically increase, and in which information has no nationality, our respective governments must re-examine their approaches to national and international policymaking.

During the recent Canada Tomorrow Conference held in Ottawa a few weeks ago, a major theme was the international character of Canada's markets. Opinion leaders are increasingly agreeing that Canada's primary business objective must be the development of world competitive enterprises. To achieve this objective, Canada needs to attract capital investment, welcome technology, and utilize our strengths in human resources.

Specifically, Canada's attitude toward foreign investment will be a deciding factor if we are to realize the benefits of the Information Age. The building blocks needed for an information society require substantial investments in both technological development and skills training. To be able to attract the necessary investment, Canada must create and maintain a positive and friendly investment climate. Government policies must be predictable and stable enough to provide investors with the degree of confidence necessary to convince them that it would be worthwhile to make long-term investments in Canada. Further, because it is unlikely that we will be able to internally generate investment on the scale necessary to support our future technological development, we will have to re-examine our attitudes toward foreign investment.

As you are aware, foreign capital has historically had a very important place in Canadian economic development. Canada has relied heavily on the process of international investment to finance the development of its infrastructure, resources and manufacturing sector. However, the presence of strong economic nationalist sentiments within the economy has often hampered the promotion of foreign investment in the economy.

When public opinion polls ask more detailed questions, however, a different result appears. Canadians clearly recognize that foreign investment has many benefits including jobs, technology transfer and access to foreign markets. When asked if Canada should limit foreign investment if it means giving up the benefits, Canadians say 'no'. Specifically, Canadians are unwilling to limit foreign investment if it means fewer jobs.

When it deals with foreign investment, government policy will have to recognize the role of the multinational and the value-added it can bring to our economy through the transfer of technology. This is starting to happen.

The federal government's recent report on trade policy clearly states that the encouragement of new investment will be one of the major challenges facing the government as the economic recovery takes hold.

But what about the responsibilities of multinationals in Canada? Is it not reasonable to expect some level of good corporate citizenship?

Many of us in the multinational business community would be pleased if we were judged by our performance and not by our ownership. We also believe that any performance criteria should apply equally to Canadian and foreign-owned companies. I think we would stand up quite well to the comparison.

Having stated this, what constitutes performance criteria? At IBM Canada we pursue the following:

1 *Canadian management.* IBM has a longstanding policy that each subsidiary should be managed, staffed and operated by the nationals of each country in which it operates. Virtually all of our employees are Canadians and all of our Officers are Canadian.

2 *Mission specialization.* The subsidiaries should specialize in the production of a limited number of products for the international market. This permits the subsidiary to achieve the expertise and economies of scale needed to compete not only in its own markets but internationally as well.

3 *Export promotion.* Rationalization has enabled us to dramatically increase our exports, which in turn has allowed IBM to make a significant contribution to Canada's international trade in information technology.

4 *Canadian procurement.* We have a policy of locating and developing local sources of supply. In our manufacturing operations particularly, the company relies on many Canadian firms for supplies, subassemblies, and tools. Furthermore, we act as an international procurement agent for the corporation as a whole.

5 *Research and development.* Given the importance of product development to maintain international competitiveness, IBM Canada operates one of the top private sector R&D facilities in Canada. The emphasis in this lab has been in the development of end user application software.

6 *Technology Transfer.* We are committed to providing Canadians with the most advanced technology available in the world. We are engaged in developing Canada's most valuable resource – its people. Every IBM employee completes an average of ten days of education annually and we place a premium on the education of our customers. We operate the equivalent of a medium-sized university in Ontario.

As well, we have entered into several co-operative programs with leading educational institutions throughout the country to develop a wide variety of leading edge computer applications in an effort to introduce a maximum number of students to the application of information technology.

7 *Regional Development.* Through our national telecommunications network we provide an equal level of support and service to locations across Canada.

8 *Participation in Canadian Social and Cultural Life.* We are committed to full participation in and support for cultural and community programs throughout the country. In addition, to promote our national culture, we sponsor major national cultural performances across Canada.

We believe that each of these performance criteria are in accordance with Canada's national goals for social and economic development. It is critical for Canada's development that all businesses, including foreign multinationals, contribute to the achievement of national goals.

Furthermore, all levels of government must be committed to the same national goals. Recently, I have witnessed several occurrences of both the federal and provincial governments promoting Canadian content in certain procurement situations. This consideration of product content runs directly contrary to specialized missions and indeed discourages them in favour of inefficient branch plant operations. As well, certain provincial governments have carried the notion of Canadian content one step further and are requesting provincial content in certain tenders. Clearly, if this continues we will all witness a severe balkanization of the Canadian economy and achievement of national economic goals will most certainly not be met.

This issue of government intervention in the procurement process brings me to Mr. Bales' conclusion that there is a fundamental difference between Canada and the U.S. in the role that governments play in the national and local economies. This fundamental difference is the underlying cause of the friction that has arisen between the governments over investment issues.

As I often attempt to explain to my IBM U.S. counterparts, Canadians are pragmatists. Because we have not had the pools of private capital available to meet our investment needs we have turned to our governments to finance and operate some of our largest capital projects. Canadians, by and large, accept this intervention in the economy and expect business and government to work together to optimize this arrangement. However, in the upcoming decade we will be faced with some new challenges.

To restate an earlier point, some of these challenges that must be met in an evolving Information Age will include:

- a full understanding of the strategic implications of an information society;
- accepting the fact that the rate of change will accelerate;
- adopting flexible public policy strategies;
- providing an economic, political, and social environment which is supportive of the wealth-generating institutions in its society.

In this context, many of our policies, programs, and initiatives in place today will have to be significantly modified. For example, if Canada succeeds in getting the benefits which a maturing Information Age will offer, by acquiring capital investment wherever it is available and technology from wherever it exists, we will be able to produce goods and services in greater quantity than will be needed to satisfy our national markets.

The question therefore arises, can we afford to isolate ourselves from the world economy? To again reference the federal government's report on trade policy: 'Canada is crucially dependent on trade to maintain the current standard of living'. I doubt if pragmatic Canadians would agree with isolationism for very long. Indeed, our economy will become increasingly dependent on having easy access to international markets. It follows that Canada will have to advocate the removal of barriers to trade and investment not only with respect to goods but also with respect to services and technology. Moreover, Canada will have to adhere to the principle of national treatment with our trading partners. Similarly, to be consistent and to avoid the possibility of retaliation, Canada will not be able to have one set of rules for its national firms and a different set of rules for all others.

Canada's attitude towards international trade and investment will be a major cornerstone in the success or failure of our economic well-being and must be a prime focus throughout all levels and functions of government. We will need to do a much better job of co-ordinating our national policies with our international policies, to ensure that the two can be made to work in harmony.

Canada/U.S. energy issues: a Canadian perspective

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University of Western Ontario

INTRODUCTION

The Canada/U.S. energy relationship is multidimensional, complex, and always changing. I do not propose to deal comprehensively with or even cursorily with all or most of the issues involved, partly because I am constrained by time and space but mainly because I lack the expertise – or think I do. Given the multitude and complexity of the fiscal and regulatory interventions in the energy field there is a temptation to conclude that free market solutions must have been proven wrong and that market failure is rampant. The more likely explanation is that the totality of interventions is just the legacy of governmental efforts at two levels to deal with the equity-efficiency-security tradeoff. Dealing with this tradeoff seems to have been a more difficult problem for Canada than for the U.S., partly because energy resources are so unevenly distributed, partly because ownership and control is largely in foreign hands, and partly because the two levels of government have overlapping jurisdiction over energy matters.

My aim in this paper is to focus on three of the central issues that are involved in the current Canada/U.S. energy relationship: first, issues raised by each country's choice of an energy pricing policy; second, issues raised by the large volume and value of trade in energy that continues to take place between the two countries; and third, issues raised by the substantial degree of U.S. ownership and control of Canada's energy sector.

From a Canadian perspective these issues have taken the following form:

- on pricing, should Canada establish its own price for energy?
- on trade, should Canada sell off its energy resources rather than use them strategically as a basis for industrial development?
- on investment, should Canada export a greater controlling interest in its energy sector?

I want to address each of these questions and consider the way they have been answered by Canada's National Energy Program (NEP) and by subsequent events. One theme that I hope will eventually become clear is that, contrary to popular belief, in many respects the NEP is not a radical departure from previous government policy, but rather a clarification and extension of it. This observation is neither an endorsement nor a condemnation of the NEP *per se*. While the goals of security, opportunity, and fairness are reasonable enough, the methods used to attain them were far from efficient. To some extent many of the flaws in the NEP policy package reflect the fact that it was the outcome of a federal-provincial bargaining process that is inevitable given the Canadian Constitution. The NEP suffered the fate of any rigid set of rules and regulations established in a volatile and unpredictable environment. The whole experience should teach us that future policy must be more flexible and in particular must reinforce the market mechanism rather than impede it or run counter to it.

ENERGY PRICING

World prices for oil: more flexible pricing for natural gas

Economic efficiency, of course, points strongly towards the adoption of world oil prices in both the U.S. and Canada whether or not those prices are dictated by a cartel and bear little relationship to the true economic cost of oil. Indeed, there are sound reasons why oil prices within each country ought to *exceed* world oil prices: first, because reliance upon secure indigenous sources is preferable to dependence upon an insecure foreign source (i.e., OPEC); and second, because world oil prices may well be driven downward by such an initiative.

But whereas the U.S. fully decontrolled crude oil prices in February 1981, the Liberal Government in Canada chose to honour an election campaign commitment and adopted a blended oil price, which effectively charges consumers (i.e., refiners) throughout the country the average cost rather than the marginal cost of oil. The post-NEP decline in world oil prices has tempered the economic efficiency argument against a blended price system since the average price in Canada is now in excess of 90 per cent of the landed cost of imports. Moreover, amendments to the NEP have significantly expanded the range of oil that qualifies for world prices so that it now includes 30 per cent or more of current production, and this percentage will continue to grow. Nonetheless, Canada remains open to criticism from the U.S. and other countries regarding its oil pricing policies. Because Canadian consumers are offered both a lower and a more predictable oil price they continue to receive false signals about the true cost of oil, and Canada continues to import more oil than it would do under a fully decontrolled system. As well, access to cheaper oil in Canada gives all firms operating in Canada an artificial competitive advantage over their U.S. counterparts. Cheap oil should not be an element of Canada's industrial policy.

There have been at least three reasons for Canada's reluctance to move completely to world oil prices. First, since two-thirds of the industry remains foreign owned, full decontrol under present fiscal arrangements would transfer income from Canadians to foreigners leaving Canadians as a whole worse off;[1] second, more individual Canadians would stand to lose rather than gain from full decontrol given that the redistributive mechanisms for ameliorating disadvantaged groups are severely constrained by Canada's being a federal and not a unitary state; and third, decontrol means that oil recovered using conventional techniques from wells discovered before 1974 would receive the world price, so that the supply response would likely be minimal. A 'made-in-Canada' price for oil that reflects the average cost of production (and therefore avoids any net fiscal drain) is politically attractive, especially if the efficiency costs of abandoning it are seen to be relatively slight and the distributive effects would be perverse.[2]

But the efficiency costs of the blended oil price system have been understated; it complicates efforts in Canada to encourage substitution away from oil to a more abundant energy source (natural gas). The NEP reversed the direction of previous policy and undertook to preserve the wholesale price of natural gas in all markets in Eastern Canada at 65 per cent BTU parity with the *domestic* oil price. (Prior to the NEP, natural gas had been scheduled to move steadily to *full* BTU equivalence with oil.) While the pace of 'off-oil' substitution since 1980 has been impressive, progress in converting from oil to natural gas has been constrained by delays in expanding the natural gas transmission and distribution systems (both eastward into Quebec and the Maritimes and westward to Vancouver Island), and by the availability of low-priced (but not necessarily low-cost) electricity. In 1980, natural gas was being sold at a discount to encourage substitution from oil with the unfortunate side effect of encouraging wasteful consumption. Under present conditions the same policy tends to keep natural gas prices from falling, thereby impeding off-oil substitutions.

It is primarily for this latter reason that Canada should abandon its blended oil price scheme and allow the *consumer* price of oil (i.e., the price paid by refiners) to move freely to the world level. Raising the producer price of conventional old oil to the world level at the present time is problematic, given the undesirable distributive effects and given no strong evidence of a significant supply-side response.[3] But if world oil prices should fall to the level of the current price of conventional old oil ($29.75 Canadian) the producer price for all oil in Canada should be equated to the landed cost of imports less pipeline transmission costs, but averaged over, say, a 3- to 6-month period. A domestic producer price that is on average equal to but less volatile than the world oil price would tend to favour secure indigenous supply over insecure foreign supply at the margin. If natural gas were to maintain its present substantial price discount vis-à-vis the fully decontrolled domestic oil price, this would continue to provide a powerful incentive for consumers to switch from oil to natural gas while avoiding at least some of the waste that is an unfortunate by-product of current policy. It would also bring Canadian oil prices more into line with those in the U.S. and thereby provide a climate more conducive to production and investment decisions based upon long-run economic efficiency.

But why should the domestic natural gas price be maintained in some arbitrary fixed ratio to the domestic oil price? Would it not be preferable to decontrol domestic natural gas prices as well, or at least move to a more market oriented approach where the price is sensitive to the shifts in supply and demand that are bound to occur and cannot be foreseen?

Canada's natural gas pricing policy seems to be governed by two principles: first, that the ultimate value of natural gas in a world of insecure foreign oil reflects the ability of gas to displace oil, but that individual consumers must be heavily subsidized to switch from oil to gas because they are unlikely to bear the full burden of a sudden oil shortage or a sharp increase in its price; second, that it would be difficult to justify as a long-run policy the sale of Canadian gas to the U.S. for less than the price paid by other Canadians even though differences in transport costs may fully explain the difference. In fact, a stronger version of the second principle has held sway until quite recently; it states that Canada's reservation price for natural gas exports ought to reflect the value of natural gas to Canada as a means of displacing imported oil, not just the price that other Canadians are willing to pay for it.

When the NEP was first introduced in 1980, world oil prices were forecast to rise steadily at roughly two per cent per year in real terms for the foreseeable future. The policy of pegging the domestic natural gas price to the domestic oil price at a substantial discount on an energy-equivalent basis was seen as key to solving Canada's oil import vulnerability problem. It also seemed to ensure that a large proportion of the economic rent from the steadily increasing value of natural gas would be captured by Canadians (as consumers) rather than by foreigners (as owners of gas production and distribution facilities). In the meantime, if the natural gas export price were maintained at 85 per cent of the world oil price on an energy-equivalent basis, Canada would receive full value for any gas deemed surplus to Canadian needs. The export price was not seen to be a major deterrent to export sales, given the progressively tight world oil market and the prospect of a growing oil import vulnerability problem in the U.S. In fact, Canadian gas would actually be a bargain for the U.S. given that it was a secure source of supply whereas OPEC oil was not.

World oil prices have fallen dramatically since 1980, of course, while (thanks to the NEP) domestic natural gas prices have risen steadily for producers, if not for consumers. Additions to established reserves have continued to exceed domestic requirements plus exports. The external market for natural gas is now much less favourable for Canada because the drop in world oil prices has dampened the global sense of urgency about oil substitution, and because the phased decontrol of natural gas prices in the U.S. has eroded the extent to which Canadian gas can be 'rolled in' with cheap but scarce U.S. gas in interstate markets. Whereas the concern about a free market price for natural gas in 1980 seemed to be that it would rise toward full BTU equivalence with oil (and thereby deter substitution from an insecure energy source to a secure one), the fear in 1984 is that natural gas prices will fall and Canadians will begin to use gas wastefully with insufficient regard for the welfare of future generations.

What the experience since 1980 illustrates is that setting the domestic price of natural gas in some fixed ratio to oil guarantees that the price will either be too high or too low most of the time - that either too much or too little price incentive for oil substitution will be offered at each date, and that Canadians will either be too prudent or too shortsighted in their intertemporal allocations. As Helliwell (1980, 19) observes, moving to a more market-oriented approach would transform shut-in, would-be producers into either producers or content investors in nonproducing reserves. Under present conditions, natural gas prices would fall for consumers and producers alike. This would not only provide greater incentive for consumers to switch from oil, but also tend to transfer income toward Canadians since so much of Canada's natural gas industry remains in foreign hands. Ironically, if the rigid price regime for natural has has now become a floor rather than a ceiling, the celebrated NEB goals of security, opportunity and fairness are all being thwarted.

If the domestic natural gas price continues to be pegged to the domestic oil price there will be growing pressure to offer price discounts to selected classes of domestic users over others, e.g., to firms who use natural gas as feedstock in the production of exportables under highly competitive world market conditions such as the petrochemical industry, or to large industrial users who agree to purchase volumes in excess of some minimum. Higher prices would likely be maintained for captive residential users, whereas prices would be reduced to promote sales in new residential markets which are typically in the most remote and least economic locations. But all these schemes would be inefficient ways of promoting other goals such as the promotion of exports, employment, or oil conservation; there are less costly ways of producing the same results.

Some difficulties with full decontrol of domestic natural gas prices

Until fairly recently, U.S. concern about Canadian natural gas pricing seemed to focus on the discriminatory features of a two price system that tied the domestic wholesale price to 65 per cent BTU parity with the domestic oil price but set the export price at 85 per cent BTU parity with the higher world oil price. From the perspective of an American (as well as perhaps an Albertan), such a system constitutes a wasteful divergence from an efficient continental allocation of a scarce resource, yielding a significant real income loss to the country as a whole. But U.S. objections to the two-price system tended to be muted by an appreciation of the fact that it was better to have access to relatively expensive Canadian gas than access to no gas at all. There was also perhaps some recognition of the benefits to Canada, and to other oil importing countries, of Canada backing out of imported oil. If Canada could demonstrate that oil self-sufficiency was a feasible and attainable goal, it could provide a powerful inducement to other oil importing nations. In any event, the U.S. could hardly object to Canada's rigid pricing structure given its own comprehensive and stringent controls on natural gas prices.

The phased decontrol of natural gas prices in the U.S. set in motion by the Natural Gas Policy Act of 1978 (NGPA) has given further impetus to U.S. criticism of Canada's natural gas pricing policy. The criticism has not been directed at natural gas pricing practices within Canada (natural gas prices are currently higher in Canada than in the U.S., where decontrol has tended to increase supply, but demand has remained depressed), but rather at the uniform border price for exports that has been in place since 1977. In a recent policy statement, the U.S. Energy Regulatory Authority (ERA) has put Canada on notice that the terms and conditions of future export contracts will have to be freely negotiated between buyer and seller, and that the price will have to be more sensitive to regional market conditions and competitive with domestic supplies in the U.S. (see *Globe and Mail* 17 February 1983).

If Canada were to move completely to a free market system, a producer of natural gas in Alberta would presumably insist on the same price for his gas whether it was destined for U.S. consumers in

Minneapolis or Chicago, or whether it was destined for Canadian consumers in Toronto or Montreal. But because of genuine differences in pipeline transmission costs, prices for Canadian gas for consumers in eastern Canada would be higher than prices paid by U.S. consumers in the midwest. This outcome may or may not be economically efficient from a Canadian perspective; it depends upon whether there is a divergence between the price Canadians are willing to pay for gas and the marginal social benefit of natural gas consumption within Canada. In any event, the outcome that a completely free market for natural gas would produce would likely create political difficulties within Canada. It may be worth developing these points in further detail.

Critics of Canada's energy pricing policies have called for world prices for gas as well as for oil without pausing to clarify or reflect on what this means. There is no world market for a unit of natural gas in the sense that one exists for a barrel of oil. Because of the enormous fixed costs involved in transactions (e.g., the costs of pipeline construction, and in the case of LNG, the costs of liquefaction, shipment, and regasification) contracted volumes must be large, they must extend over lengthy periods, and the pricing formula is usually specified in the contract. For Canada, the relevant export market is via pipeline to the U.S., and even though Canada supplies only 4 to 5 per cent of this market, the volume of sales appears to be sensitive to the price Canada charges. If Canada cannot buy or sell additional amounts of gas at the going price, a 'market clearing' price for Canadian gas in the U.S. would overstate the true social opportunity cost of natural gas to Canada. Using 'world prices' for natural gas sales within Canada would therefore tend to bias allocations toward the export market and impose overly stringent conditions on domestic use. World market conditions for natural gas from a Canadian perspective are very much in the hands of the U.S. regulatory authorities, just as world oil prices are in the hands of OPEC.

If there were little scope for interfuel substitution between oil and gas then it would make sense to treat oil and gas separately for purposes of energy policy, and prevailing market conditions in the U.S. (distorted as they might be) ought strongly to influence price and allocation decisions within Canada. But to the extent that the two energy forms are highly substitutable across a wide range of applications and Canadian demand will expand to absorb large amounts of gas once the necessary infrastructure is put in place, it makes sense for Canada to value natural gas in terms of its ability to displace oil. Whether this implies a high reservation price for natural gas exports depends upon the length of the export contract, and whether Canada perceives itself as being supply-constrainted or demand-constrainted. For contracts to supply large volumes on a firm basis over long periods when the cost curve reflecting the full economic cost of reserve additions is judged to be high and steep, a high reservation price for exports is justified because such exports can be seen to be in competition with meeting future domestic requirements. But for contracts to supply smaller volumes for short periods and in a climate where surplus reserves clearly exist, a lower export price would be warranted.

As for the alleged 'political problems' with a market solution, Canadians should begin to ask themselves whether the country needs a single price for oil and gas from coast to coast to sustain itself. If so, domestic oil and gas pricing policies must be viewed as yet another example of the use of very expensive glue to hold a fragile country together.

Some conclusions about oil and gas pricing

What conclusions about energy pricing follow from the above? First, consumers must be asked to pay the full replacement cost of oil (i.e., world prices) as soon as possible, and no assurance should be given to protect them from future oil price shocks through the price mechanism. Whether the producer price of conventional oil should be raised to the world level depends on two considerations – the extent to which inefficient sourcing of oil is taking place, and whether domestic natural gas prices are to be decontrolled.

Second, if Canadians are to be encouraged to switch from oil to gas it is preferable to use incentives designed to reduce their conversion costs rather than by comprehensive and discretionary discount pricing of natural gas consumption within Canada.

Third, natural gas prices within Canada must be made more sensitive to changes in market conditions so that natural gas prices are not rising when surpluses are growing and world oil prices are falling. A fixed BTU pricing rule for natural gas may have been a reasonable policy in a world of steadily rising world oil prices, but it is inappropriate in current circumstances.

Fourth, the future pricing of natural gas for export will have to be made more sensitive to prevailing market conditions abroad if Canada wants to preserve and enhance its market share in the U.S. over the long term. The rise in the world oil prices that occurred during the 1970s combined with misguided controls on natural gas in the U.S. to create an artificially attractive market for Canadian natural gas exports in which it was credible to insist on full commodity value for gas while maintaining a strong and growing U.S. demand. The phased decontrol of U.S. natural gas prices will expand the supply of relatively cheap gas in the U.S. and reduce the extent to which relatively expensive Canadian gas can be rolled in to meet U.S. demand. It appears that Canada must now choose between a high reservation price policy for its exports and a lower price that is more consistent with market conditions abroad. The choice should be based upon a careful analysis of the size and duration of the current natural gas surplus as well as the best available scientific knowledge about the cost and supply conditions for future reserve additions.

Finally, current conditions may be propitious for linkage between the decontrol of oil and gas prices in Canada. It is now widely believed that if Canada were to move toward a more market oriented system, the domestic oil price would rise quickly to the world level while natural gas prices would fall – at least in the short-run – to perhaps 50 per cent BTU parity with oil. This would be a mixed blessing for the producing provinces and for the oil and gas industry; an increase in the price of conventional old oil to the world level would raise oil revenue by approximately $2.9 billion per annum (assuming daily production of 1.0 million bbls and an $8.00 per barrel increase in the wellhead price), which would suffice to offset a reduction of $1.16 per mcf in the producer price of natural gas (assuming annual production of 2.5 tcf). The concern that has always permeated the energy pricing debate in Canada – that the implementation of replacement cost pricing for energy would result in large transfers of income and wealth from Canadians to foreigners and from eastern Canadians to western Canadians – is likely to be much less of an issue at the present time. Whatever the size of the net transfers, they would be smaller now than they would have been in the past; the efficiency gains that are available may well be worth the distributive costs. The idea of linking oil and gas price decontrol is one that warrants careful consideration by policymakers in Ottawa.

ENERGY TRADE POLICY

Energy trade has always been a controversial issue in Canada. The notion that Canadians are being short-sighted in selling off their nonrenewable resources rather than processing them into final goods or using them strategically to gain easier access to external markets for Canadian manufacturers, or retaining them for future generations, has long been expressed (most recently by Clarkson 1983). While there are certainly plausible circumstances under which each of these concerns has merit, most economists would argue strongly against extreme views such as that Canada should not export any of its oil and gas in crude form, or that Canada should maximize the employment opportunities that arise from oil and gas development, or that Canada should apply zero growth principles to oil and gas production. It should be neither surprising nor disturbing to find that during the course of economic development a natural resource rich country evolves from a state of exporting a large proportion of its resources in raw form to a state of using a growing proportion of its resources internally. The real issue is whether under freely functioning markets this happens at the correct pace and in what circumstances it is in the national interest for governments to tip the balance somewhat in one direction or the other.

In this section I review the evolution of Canada/U.S. trade in oil, natural gas, and electricity, and examine the various options available to Canada in setting the terms and conditions for exports in the future.[4]

Oil: the gradual disappearance of trade

Previous writers have suggested that the first profound change in the nature of the Canada/U.S. energy relationship took place in the early 1970s – almost a decade before the NEP (McKie 1977). Before 1970, Canada/U.S. trade in oil and gas seemed to be based upon a mutual desire to assure access to markets in order to promote domestic production. In the words of one U.S. analyst, 'there was a continentalist logic at work', and it led to a presumption – at least south of the border – that 'much of Canada's energy would eventually find its way to U.S. markets' (Wonder 1982a). In 1961, Canada's National Oil Policy (NOP) reserved the Canadian market west of the Ottawa Valley for Alberta oil despite the fact that it was more costly than oil from Venezuela and the Middle East. The eastern Canadian market was to be served exclusively by imports, primarily from Venezuela and to a lesser extent from the U.S. Meanwhile, concern in the U.S. about security of supply and the need to protect its relatively high cost domestic industry had led to the imposition of mandatory oil import quotas in 1959; but Canada fought for and received an 'overland exemption' on the grounds that Alberta's rapidly developing oil resources provided the U.S. with a secure continental source of supply, and because there was substantial cross-hauling in oil between the two countries. As a result, Canada's exports to the U.S. grew rapidly through the 1960s and early 1970s, and peaked in 1973 at more than 1.2 mbd, which was almost 60 per cent of Canadian production.[5]

But by the early 1970s energy security had become a preoccupation in both countries as each faced the prospect of vulnerability to any disruption in the supply of offshore oil. Under the NOP Canada has been transformed from a net oil importer to a net oil exporter, yet it still remained heavily dependent upon OPEC. Nevertheless, given the enormous potential of the Alberta tar sands, oil self-sufficiency was a feasible policy choice for Canada even though it was generally acknowledged that Canada's *conventional* oil production was about to enter its declining phase. (Production also peaked in 1973 at about 2.0 mbd.) Oil self-sufficiency was not, however, a realistic option for the U.S. It had become increasingly difficult for the U.S. to justify Canada's preferential treatment under the oil import quota. The exemption enabled Canada to sell relatively expensive Alberta oil to the U.S. and to replace it with cheaper offshore oil. Yet there was little evidence that Alberta oil was actually more secure than offshore oil from the U.S. point of view; in the event of a global oil shortage Canada could be expected to divert its oil exports to meet its own domestic requirements first. (Oil exports were typically on short-term contracts of one year or less.) Thus, the U.S. moved to extend its oil import quota to Canada in 1970.

When the rise in world oil prices suddenly made Alberta oil attractive the U.S. withdrew the oil import quota. But Canada had now become much less expansive about its oil and gas resource potential. Even before the Arab oil embargo in October 1973, Canada imposed export controls on oil. When OPEC quadrupled world oil prices in January 1974, Canada moved to establish a uniform domestic price for oil (well below the world price) and authorized the shipment of Alberta oil further eastward via pipeline to Montreal. An oil export tax was also imposed, which effectively meant that Canada was charging the U.S. OPEC prices. While this latter policy response was completely rational and justifiable from a Canadian perspective (selling oil for less than what you have to pay for it is just foolish, and in any case if the Federal government did not move to raise the export price to the world level then the industry or the Alberta government surely would), it caused a great deal of resentment in the U.S.

In short, it was apparent from the time of the first oil price shock in 1973 that Canada and the U.S. would pursue their respective paths towards oil security more or less independently. Thus, well before the NEP of 1980, it was clear that there would be no 'continental harmonization of energy interests' whereby two countries would agree to choose least cost methods to maximize their joint welfare with respect to energy. Contrary to popular belief, the NEP was not the first bold step away from from a continental integration of energy matters.[6]

Canadian crude oil exports were gradually phased out through the balance of the 1970s and early 1980s, and the NEP neither accelerated nor deterred this process. Today, exports are primarily either swap transactions (whereby Alberta oil is shipped to midwestern U.S. refineries in exchange for equivalent volumes of U.S. oil shipped to refineries in eastern Canada), or shipments of heavy oil for which Canadian refining and upgrading facilities are inadequate.

Natural gas: confusion and uncertainty about supply and cost[7]

The history of Canada/U.S. trade in natural gas runs parallel to that for oil in many respects, but there are some notable differences. Access to U.S. markets was also crucial for the early development and production of Canadian gas, much of it being discovered in the search for oil. With the completion of the three main pipeline systems (TransCanada to serve eastern northern California, and Westcoast to service the Pacific northwest), natural gas production quadrupled from .45 tcf in 1960 to 1.9 tcf in 1970 and then increased by a further 33 per cent to 2.5 tcf in 1973. (1 tcf of natural gas is equivalent to 172 million bbls of oil in terms of its energy content.) Production has remained fairly stable at the 2.5 tcf level ever since. Exports to the U.S. increased from .11 tcf in 1960, to .77 tcf in 1970, and then to 1.03

tcf in 1973. Exports remained stable at close to 1.0 tcf (about 40 per cent of production) for the rest of the decade, but since 1980 they have declined gradually to the current level of .75 tcf, or 30 per cent of production.

Despite the declining *volume* of export sales in recent years, the *value* of export revenue has continued to grow. In 1982 revenue from exports was approximately $4.5 billion, which made natural gas the second most important element in Canada's export trade, next to automobiles. From a U.S. perspective Canada supplies only 4 to 5 per cent of total consumption. But, of course, for certain regions, especially the midwest and California, the supply of natural gas from Canada is crucial.

The recent decline in the volume of natural gas should not be interpreted as evidence that Canada has moved away from a continentalist orientation with respect to natural gas. There has never been a Canadian commitment to the continental marketing of natural gas on a least cost basis. The Borden Commission in 1958 had recommended that natural gas exports be permitted only under licence and only if they were 'surplus to the reasonably foreseeable requirements of Canada'. To be sure, it seems unlikely that Canada will find it feasible, much less desirable, to export 40 per cent of its annual production on a sustainable basis. But in fact the recent decline in the export share to 30 per cent is more a reflection of weak demand conditions in the U.S. (and high export prices by Canada) rather than a genuine concern about resource depletion in Canada.

However, in 1971 a potential conflict did arise between the approval of additional exports and the meeting of future domestic requirements. At that time future export commitments amounted to 17 tcf, with 7 tcf of additional exports having been approved in 1970 on long-term contracts even though the pipelines required to ship the gas were already in place.[8] Meanwhile, U.S. pipeline companies were aggressively seeking additional supplies of Canadian gas because wellhead price controls were beginning to create shortages in the interstate market. But the NEB rejected all export proposals in 1971 and again in 1974/5; no new exports were approved for the rest of the decade. Forecasts of the deliverability from Canada's established reserves plus anticipated reserve additions from nonfrontier areas were revised downward in the early 1970s, and forecasts of Canada's future domestic requirements were revised upward. There turned out to be very weak analytical support for these sharp revisions, but the perception shared by government, industry, and the public until as late as 1977 was that the 1970 export decision had been a serious mistake and that as a consequence Canadians would begin to experience natural gas shortages by the mid-1980s unless frontier reserves were speedily developed.

By 1978 it was apparent that Canada had a 'gas bubble' to contend with rather than a gas surplus. The early 1970 demand forecast had been essentially an extrapolation from the unusually high growth experience of the late 1960s, with no provision for the dampening effect of price increases and little appreciation of the difficulties and delays involved in penetrating new markets. As well, the supply forecast downplayed the effect of rising wellhead prices on deliverability from established reserves as well as being overly conservative about the contribution of reserve additions. In fact, from 1976 to 1980 cumulative additions to natural gas reserves were 29.5 tcf while cumulative production was only 12.4 tcf (EMR 1982a, 56).

The prospect of growing surpluses led to the 1979 NEB decision to approve 3.9 tcf of additional exports over the period 1980-87 (of which 1.9 tcf were authorized under the pre-build arrangement with the U.S. as part of the Alcan pipeline project).[9] However, since 1980 a myriad of factors (depressed economic conditions, mild winters, phased decontrol of U.S. natural gas prices, a soft world oil market, and Canada's insistence on full commodity value for its exports) have resulted in weak markets for Canadian natural gas such that by 1982 actual exports were only 63 per cent of authorized volumes. In 1983 the NEB approved a further 11.6 tcf of exports over the period 1983-2000 (of which 2.3 tcf were authorized to Japan via LNG), but for 1982 actual exports had declined to .73 tcf, or just 44 per cent of authorized volumes.

Natural gas surplus determination criteria: too stringent or too weak?

Any decision to export natural gas inevitably brings forward the date at which higher cost reserves must be found and developed to satisfy future domestic requirements. This is true both from the standpoint of the producing provinces (who have their own surplus determination criteria) and from the standpoint of Canada as a whole. Rising and volatile world oil prices and a growing recognition that, except for expensive tar sands oil, Canada's future oil potential is limited has made the Federal government increasingly protective of Canada's seemingly abundant, yet highly uncertain, supply of natural gas. Ottawa tends to view natural gas in terms of its ability to displace imported oil, and as the key to oil self-sufficiency. The need to know more precisely how much gas (and oil) there is has been used to justify rich incentives to explore for additional reserves which has led to substantial reserve additions. Uncertainty of supply has also been used to justify fairly stringent constraints on the amount of gas available for export, and the adoption of a high reservation price for the gas that is deemed to be exportable.

Under the current system, the NEB defines a surplus by comparing established reserves to 25 times the current year's domestic requirements plus an allowance for previously authorized exports. A surplus is deemed to be exportable provided that the deliverability profile from established reserves plus forecast reserve additions exceeds the forecast of domestic requirements plus anticipated exports for several years into the future. Forecasts of domestic requirements plus exports depend upon a domestic energy pricing policy and a scenario for the future course of world oil prices. The deliverability forecast depends upon assumptions about the number of wells drilled, the rate at which wells are connected, and the rate at which production flows from connected wells. Export proposals are evaluated and compared on a 'stand alone' basis, and take into account various other factors such as the likelihood of the supplier being able to deliver the full commitment and the buyer being able to take a high proportion of it, the financeability of any additional pipeline extensions that may be required, the special need for small producers with shut-in reserves suffering cash flow problems to have ready access to new markets, and the advantages of diversifying the export market. Additional export contracts may be awarded provided that they can be shown to be of significant net economic benefit to Canada, i.e., provided that the present discounted value of the extra revenue from exports less the incremental transmission costs exceeds the extra cost to Canadians in having to use higher cost gas sooner than would otherwise be the case.[10]

The policy thus minimizes the chances that some future domestic requirements might not be met because of an export commitment, or that an export commitment might not be honoured because of the need to satisfy a domestic requirement. It recognizes that large and lumpy investments must be made to extend the domestic transportation and distribution systems and that the worth of such investments is predicated on access to adequate supplies of natural gas over the lifetime of the investment. On the other hand, if forecasts of domestic requirements are based upon natural gas prices set below opportunity cost, the policy guarantees that some lucrative export opportunities will be foregone to protect future domestic requirements of less economic value.

Proponents of a more open export policy argue that net economic benefits to Canada are being dissipated by a reserves formula that requires reserves to be established far in advance of production and that results in the holding of large inventories of shut-in gas at each date. Because of long delays between discovery and production, incentives to explore must be richer than they otherwise would be, and the full economic cost of supply is higher. Further, they argue that the deliverability appraisal reflects an unwarranted pessimism about the supply and cost conditions for future reserve additions. In support they cite the steady upward revision in NEB estimates of total recoverable reserves (for Alberta alone these estimates have risen from 114 tcf in 1975 to 120 tcf in 1977, to 138 tcf in 1981, and to 146 tcf in 1983). Finally, they cite the mobility of drilling rigs as clear evidence that exploratory effort, and therefore future deliverability, is highly sensitive to anticipated market conditions. According to this view, restricting access to markets for fear of future supply shortages, or to conserve supply for future generations, will raise the overall cost of supply and induce the shortages.

Proponents of a more restrictive export policy tend to view natural gas as a strategic resource that should be preserved as part of the national patrimony for use by future generations. According to this view, gas that is surplus to domestic requirements should be exported only if those exports facilitate access to foreign markets for the sale of other manufactured goods. If large surpluses of gas do develop and pressure grows to export them, then the incentives to explore for and develop resources must be too generous and the resources involved in exploration and development too great. Gas might better be left in the ground undiscovered so that it can meet some future domestic requirement. For small Canadian-owned firms with surplus gas, the government should either purchase surplus gas and hold it for the future or permit gas to be exported on short-term contracts while taking steps to reduce the incentive to explore. According to this view, the problem with exports of nonrenewable resources is that it encourages the present generation to hitch a ride on its resource base rather than to earn its way in trade. The export of nonrenewable resources also tends to displace exports of other goods, typically manufactures which make more intensive use of labour.

Most economists find it difficult to sympathize much with the restrictive export policy as it is presented above except to say that one could imagine a chain of market failures that might make it a sensible policy. But since the necessary market failures are rarely ever clearly specified, one tends to reject the policy prescription out of hand. Let me simply observe here that only if the consumption of natural gas were all that mattered to future generations of Canadians would it make sense to pursue a zero export policy. Since I believe there is general agreement that future generations of Canadians are interested in a broader range of commodities, then governments should be interested in pursuing policies that contribute to this end, and that normally means taking advantage of export opportunities whenever they exist whether for nonrenewable resources or for other goods.

Proponents of a more open export policy are correct to criticize the ad hoc definition of surplus reserves, and the mechanical construction of a deliverability profile independent of market conditions. Nonetheless, I think that because the supply, and especially the cost, conditions for future reserve additions remain highly speculative and uncertain and because the price Canada can obtain for its natural gas exports depends upon the amount it supplies, the NEB has a legitimate role to play in constraining the amount available for export. Given the uncertainties involved and given past history in this area, the NEB must maintain considerable flexibility in ensuring that future domestic requirements can be met. From a national perspective it is better to err on the downside rather than have optimistic projections lead to export commitments that have to be breached. Canada must strive to maintain its image as a secure and reliable energy source of the U.S., which means that all export contracts must be honoured. If Canada is perceived as a secure source of supply a high export price becomes more palatable.

Natural gas export export pricing: commodity equivalent value or market value?

The recent experience with growing surpluses of 'shut in' gas has brought about pressure to modify the rigid export pricing policy that has been in place since 1975. At that time the Federal government intervened to resolve a pricing impasse that had developed between the Alberta government and TransCanada pipelines, and the eventual result was the establishment of a uniform border price for natural gas exports equal to 85 per cent BTU parity with the landed cost of imports (see Watkins 1977). The wholesale price of natural gas at Toronto was set equal to 85 per cent of the lower domestic oil price. In effect, an export tax was imposed on natural gas, with the Alberta producers receiving a *pro rata* share of the difference between the Alberta border price and the export price.

In the mid-1970s climate of impending natural gas shortages, it made a great deal of sense to link the export price of natural gas to the cost of imported oil. But, as discussed earlier, whether such a rigid pricing structure is in the national interest in the present climate of growing natural gas surpluses is quite another matter. The uniform border price increased steadily with the rising cost of imported oil from $1.60 per mcf in 1975 to a peak of $4.94 (U.S.) per mcf during the period 1981-3, even though actual exports were starting to fall noticeably below authorized volumes. In April, 1983 by decision of the federal Cabinet the export price was reduced by 11 per cent to $4.40 (U.S.) per mcf – a price which now represents 85 per cent BTU parity with the world oil price. In addition, export sales in excess of 50 per cent of authorized volumes are now eligible for a discount price of $3.40 (U.S.) per mcf, which approximates the current wholesale price of natural gas in eastern Canada.

During the past year several groups have advocated that Canada move towards a more market oriented approach to the pricing of natural gas exports (e.g., the NEB, concerned about maintaining the integrity of gas export contracts so as to ensure the financing of new pipelines and construction facilities; the pipeline companies, concerned about sales volumes and the underutilization of existing facilities; and at least one producing province (British Columbia) concerned about the erosion of its natural gas export revenues). It seems to me that Canada should proceed cautiously down this path, but there are some elements of flexibility that if adopted would clearly be of benefit to Canada.

An ultimate objective of Canadian natural gas export policy should be to maximize the present discounted value of the revenue from exports of gas deemed surplus to Canadian requirements. Canadians should not be mesmerized by the large export volumes that are purported to be unattainable if price are set on a competitive basis. Recent estimates suggest, for example, that by 1987 Canadian exports to the U.S. could double to 1.6 tcf if Canada were to abandon its rigid price system and permit prices to be freely negotiated between buyer and seller. But the relevant questions to ask are: what would Canada's sales volume be if it were to maintain its existing price structure; and what price reduction would achieve a doubling of export volumes?

The U.S. Energy Regulatory Agency (ERA) has recently indicated that no new import contracts will be authorized unless Canada adopts a market oriented approach to export pricing, but that all existing contracts will be respected. For Canada this means that all export contracts in place prior to and as a result of the 1979 NEB export hearings will be honoured, but that most of the 1983 NEB export approvals will be subject to the new guidelines. The U.S. decision would seem to force Canada to move toward a more market oriented approach if it wants to maintain access over the long run. But Canada should not rush to sell unregulated natural gas into what continues to be a highly regulated U.S. natural gas market.

Nonetheless, it seems to me that there are two elements of export price flexibility that Canada could profitably introduce at this time. The first is to permit the export price to vary at different border points, and the second is to permit lower export prices for so-called spot purchases of natural gas (i.e., purchases which require no commitment of reserves and no additional installation of delivery facilities, and which are clearly not displacing higher-priced sales on long-term contracts).

Under the current uniform border price regime the U.S. pays the same price for Canadian gas whether it is shipped from Monchy, Saskatchewan, Huntington, B.C., or Niagara Falls, Ontario. As a consequence, Canadian gas tends to be overpriced in the U.S. midwest and Pacific northwest and underpriced in the U.S. northeast. One condition for optimal exports to the U.S. market is that the real net back to the producer be the same for sales at each location; this is clearly not the case at present, given the substantially higher real costs of supplying the U.S. northeast relative to the U.S. midwest. As well, under the present system the NEB is (or ought to be) tempted to approve contracts involving shipments from border points closest to the producing provinces, whereas if export border prices varied according to the real cost of shipment a more efficient allocation of gas contracts would result. Canada adopted the uniform border price regime in 1977 at U.S. insistence because of perceived political difficulties in having different regional gas import prices. Canada should welcome the opportunity presented by recent U.S. initiatives to move toward a system where export prices are allowed to vary across regions.

As for the proposal to have lower export prices for spot purchases, it seems to me that this would be one way of circumventing the perceived political problem for Canada of exporting Canadian gas at lower prices than other Canadians have to pay for it. The point is that the two gas contracts are quite different; eastern Canadians are being assured of access to gas on a long-term basis, whereas spot buyers in the U.S. (or in Canada as well, should they meet the conditions) have no such assurance. The point has been made earlier that Canada should maintain a high reservation price for gas exports on long-term contracts since these are a secure source of supply and can be seen to be in competition with meeting future domestic requirements. But for short-term or spot transactions involving shut-in gas with little immediate alternative use, a lower export price is warranted.

One version of a more market oriented approach that has recently been proposed bears a striking resemblance to the system in place prior to 1974.[11] Natural gas producers or their agents would be permitted to negotiate the terms and conditions of export contracts with export buyers on an arm's-length basis and the contract package would then be subject to the approval of the federal and provincial governments. The terms and conditions would include volume, price, take-or-pay commitment, peak day and annual deliveries, and duration. The NEB would then decide whether the awarding of such a contract was in the national interest and the producing province would in turn evaluate the desirability of the contract from a provincial perspective.

While a more market oriented approach has much to commend it, it deserves stating that the proposals put forward to date do not ensure Canada's ability to maximize the net economic benefit from its exports. The regulatory authorities would be placed in the position of responding to individual contract proposals as they come forward rather than specifying in advance at least the broad outlines of a contract they would judge to be in the national interest. A market oriented approach is more likely to be in the national interest the more price elastic U.S. demand for Canadian gas happens to be. But if the volume of gas exports is an important determinant of the price that will be paid then some form of export price regulation is necessary to ensure that Canada obtains full value for its gas.

To underline the doubts that arise about moving to a market oriented system without safeguard provisions one need only consider the experience since 1979. Canada's natural gas exports fell from 1.0 tcf in 1979 to .712 tcf in 1983. The uniform border price was increased from $3.45 (U.S.) in 1979 to an average of $4.62 (U.S.) in 1983. (The export price was $4.94 until April 1983 and then reduced to $4.40). The decline in export sales was, of course, only partly a consequence of Canada's high export price. To isolate the price effect from other factors at work we note that total gas consumption in the U.S. fell from 20.2 tcf in 1979 to 16.9 tcf in 1983, so that Canada's share of the U.S. market fell from 4.95 per cent to 4.21 per cent. A reasonable presumption is that Canada's share would have remained unchanged if its export price had maintained its relationship with the price of alternative supplies in the U.S. Since these latter prices have moved very little since 1979 a reasonable inference is that Canada could have sold .836 tcf in 1983 if its export price had been maintained at the 1979 level. In effect, a 30 per cent increase in the export price resulted in an 18 per cent reduction in export sales, implying that the elasticity of demand for Canadian gas in the U.S. is approximately 0.6. If this (undoubtedly rough) calculation is at all reasonable, it suggests that it may well have been in Canada's interest to have raised the export price as it did over the 1979-83 period despite the fact that there was clear evidence of growing natural gas surpluses! Conversely, moving to a free market approach to natural gas export pricing without conditional safeguards runs the risk of substantial increases in export sales volumes over the next 5 years, but lower total revenues.

Proponents of a free market approach to natural gas pricing argue that under decontrol the export price of natural gas would fall to perhaps 60-70 per cent BTU parity with world oil at which point natural gas would become attractive to large industrial users. Canadian gas would then have virtually unlimited access to the U.S. market at this price and exports would be constrained more by limits on what Canada deems to be exportable rather than by limits on what the U.S. is willing to buy. According to this view, small reductions in Canada's natural gas export price would lead to relatively modest increments in sales volumes until the 60 to 70 per cent BTU threshold price is reached. Canada gets a distorted picture of the price in sensitivity of its exports from recent experience (see Govier 1983, 114-5).

Thus the answer to the question: 'Should Canada attach a high reservation price for its exports or let its export price be determined by prevailing market conditions?' depends crucially on perceptions in Canada about the ultimate supply of natural gas and its cost. If there is a substantial surplus of established reserves and the supply curve for future reserve additions is relatively elastic over a wide range – sufficient, say, to permit exports to be twice as much as at present for several years – then Canada's current pricing strategy may be placing it at a local but not global optimum. Thus, a small cut in price may cause a reduction in export revenue, but a 25-30 per cent cut in the export price might enable Canada to sell any volume it wanted. If so, doubling of exports may well increase substantially the present discounted value of the net economic benefit from Canada's natural gas reserves. If, on the other hand, the surplus is modest and temporary and the supply curve for future reserve additions is steeply rising such that the maximum acceptable increase in annual exports is no more than 25 to 30 per cent, then the free market approach would not be in the national interest and Canada's current high reservation price approach is a wise and prudent policy.

Electricity trade and electricity pricing: benefits and costs[12]

An emerging feature of the Canada/U.S. energy relationship involves electricity trade. Such trade has had a long history, but it was relatively insignificant until the 1970s, and more or less in balance; Canada exported surplus power to the U.S. during the off-peak summer months and in return purchased electricity from the U.S. during the peak winter months.

Exports have grown dramatically since 1970, while imports have declined. In addition to sales of surplus interruptible power and diversity exchanges during peak periods, Canada now exports substantial volumes of firm power to the U.S. on limited term contracts of 5 to 10 years. The primary reason for this has been the rising cost of fossil fuels and the availability of surplus and relatively cheap hydroelectricity from Canada. Electricity exports in 1982 were worth approximately $1.2 billion and amounted to more than 9 per cent of Canada's production. While Canada supplied only 1.5 per cent of the total U.S. market, for the northeastern U.S. market Canadian exports satisfied 10 per cent of demand.

A philosophy of export promotion subject to meeting Canadian demand has prevailed since 1963. It recognizes the mutual advantages of electricity trade as a means of permitting more efficient utilization of generation capacity in both countries as well as ensuring that efficient scale facilities can be built in advance of demand.

In 1982, the federal government endorsed the policy of pre-building capacity in advance of domestic demand subject to 'an equitable distribution of the risks and financial burdens between buyers and sellers and satisfaction of appropriate environmental standards' (EMR 1982a, 64-7). Federal government support for electricity exports extends beyond hydro-based facilities to include nuclear power that may be dedicated initially for the export market, provided that pricing, risk sharing, and environmental criteria are met. A clear aim is to preserve and promote an international market for the CANDU reactor (EMR 1982c, 42-52).

Although Canada's electricity is produced primarily by provincial Crown corporations, federal jurisdiction over international and interprovincial trade means that the NEB decides whether exports are surplus to Canadian requirements and whether the price charged is in the public interest. Neighbouring utilities in other provinces are given the first right of refusal for any proposed exports under the same terms and conditions. The specific criteria for the pricing of exports are: first, that the price not be less than the cost of production; second, that it not be less than the cost of comparable service to Canadians; and third that it not be materially less than the cheapest alternative available to the U.S. purchaser.

Canada consumes 30 to 40 per cent more electricity per capita than does the U.S., and this is largely, but not exclusively, due to substantial differences in its price; prices for residential users are typically 50 per cent higher in the U.S. The large price differential together with the provision that export prices not be materially less than the cost of the next-best-alternative to the importer suggests that electricity exports provide substantial net benefits to Canada. However, there are reasons for believing that these benefits may be largely illusory.

Without question, Canada has great natural advantages in the production of hydro electricity. The central problem is that the price currently charged for electricity reflects the historical embedded financial cost of the system in place rather than what it would cost in real resources to add to the system. For example, Ontario Hydro's $.5 billion annual profit from its hydro facilities is being used to subsidize the costs of new coal and nuclear facilities.[13] But beyond this, the provincial Crown corporations that dominate the electric power industry are exempt from federal corporate income taxes, and most are also exempted from payment of provincial corporate income and sales taxes. As well, their debt is guaranteed by their respective provincial governments, thereby reducing significantly their financial cost of capital compared to that of other privately owned utilities (e.g., regional natural gas distributors). Finally, most provincially-owned hydro corporations are required to charge the minimum rates for electricity which will enable them to recover their *financial* costs. The consequence of all this is that electricity is being sold in Canada – and is perhaps also being exported to the U.S. – at well below its full replacement cost.

If the financial cost of capital to Ontario Hydro and other provincially-owned hydro corporations understates the true social opportunity cost of the capital employed, then an excessive amount of investment in electricity generation is taking place and it is biased towards capital intensive hydro and nuclear facilities. If the total capital employed in electricity generation were required to earn the social discount rate of 7 to 10 per cent real rather than the historic average financial cost of capital of 4 to 5 per cent real, then electricity rates would have to rise by 50 per cent or more on average. Given that the price elasticity of demand for electricity is not zero, such a move toward replacement cost pricing would result in further underutilization of existing capacity. Higher electricity rates at home would justify – and require – higher rates for exports to the U.S. under current NEB pricing arrangements, and this would reduce the volume of surplus power that is currently being exported.

Critics argue that a cost of capital of 4 to 5 per cent in real terms accurately measures what it has cost Ontario Hydro, for example, to finance electricity expansion in Canada and that it would be foolish to assume that it costs the economy as a whole more than this. They reason that since the funding for expansion comes either from the surpluses earned on existing facilities or from incremental borrowing in the U.S., no displacement of private investment or consumption takes place in Canada. Since the federal government typically borrows at home rather than abroad the social discount rate for public investment decisions at the federal level is not relevant.

But there are serious problems with this argument. First, it presumes that the mere decision to borrow abroad rather than at home lowers the opportunity cost of funds, and second it assumes that the opportunity cost of retained earnings is less than for other sources of funding. In a well functioning capital market there can be no difference whether the initial act of borrowing occurs at home or abroad; the ultimate sourcing will be the same because other market participants will make accommodating adjustments. As well, the retained earnings could have been used to retire some outstanding debt so that the use of these funds has precisely the same opportunity cost as new borrowing. The argument is therefore tantamount to using the interest rate on federal government bonds as the appropriate discount rate for federal government investment decisions rather than the rate of return on private investment and consumption foregone.

Even if one concedes the point that provincial Crown corporations ought to be subjected to the same cut-off rate for investment decisions as the federal government, critics argue that it makes no sense to price existing electricity production so as to recover the social rate of discount when there is substantial excess capacity. This argument would be compelling if no new additions to capacity were being contemplated in the foreseeable future. But where such additions are being undertaken the cost to users should reflect the full opportunity cost of the resources required. If electricity is priced to earn a return of 4 to 5 per cent real when the capital employed has come to at the expense of other investments that would have earned 7 to 10 per cent real then Canadians are worse off. To the extent that the price charged for electricity exports is closer to the price paid by other Canadians rather than the next cheapest alternative in the U.S. Canada is pursuing a long-run policy of exporting electricity at a loss.

The implementation of replacement cost pricing for electricity would reduce substantially the growth of additional capacity, release resources for alternative investments, and lower Canada's external indebtedness. The consequences are not insignificant: In 1982, investment in electric power was $8.2 billion or 11 per cent of total private plus public investment in Canada. Higher electricity rates would also accelerate the switch to natural gas and absorb surplus reserves more rapidly than has been estimated. Forecasts of future domestic requirements of natural gas would have to be revised upward, and the NEB would want to be considerably more cautious about approving additional exports for long periods. A high reservation price for natural gas exports on long-term contracts would suddenly begin to make a great deal of sense.

Since electricity pricing within Canada is a provincial matter, it is difficult to envision rapid implementation of replacement cost pricing – especially since provinces have long viewed cheap electricity rates as a means of attracting industry and giving a competitive edge to exports of industrial goods. Nevertheless, electricity may prove to be an almost irresistible source of tax revenue for provincial governments in the future, and if so electricity rates would rise. The federal government may also move to include the rents from electricity generation in the tax base for equalization (which would be equivalent to imposing a tax on electricity consumption in Canada) as well as to impose an export tax on electricity in order to be seen as treating all energy forms symmetrically. The implementation of replacement cost pricing for electricity gains greater intellectual support if oil and natural gas prices are to be decontrolled.

THE FOREIGN OWNERSHIP AND CONTROL ISSUE AND CANADIANIZATION

Previous sections have dealt with issues surrounding energy pricing and energy trade, and it is now time to consider energy investment – specifically issues raised by the substantial degree of foreign (primarily U.S.) ownership and control of Canada's energy sector.

With its enormous land mass, sparse population, and limited supply of indigenous saving, Canada has long relied on access to U.S. financial, entrepreneurial, and risk capital to develop its energy resources. While few would question the benefits of such a strategy, its legacy is an extremely high level of foreign ownership and control in the oil and gas sector and a large international debt load stemming from the financing of electricity generation. It was government policy prior to the NEP to raise the level of Canadian ownership and control of oil and gas production, although Canada's heavy reliance on the international capital market to finance electricity generation was not, and has not been, an issue. The NEP clarified the policy objectives with respect to ownership and control of oil and gas and put in place new instruments to achieve these goals. There has been a lot of rhetoric on both sides of the so-called 'Canadianization' aspect of the NEP and I do not propose to contribute further to it here. My aim is to clarify its costs and its benefits as objectively as an economist – who also happens to be a Canadian – can.

The objectives of Canadianization are:

- to increase the share of Canadian *ownership* of production revenue from oil and gas from approximately 26 per cent as of October 1980 to 50 per cent by 1990
- to achieve Canadian *control* of a significant number of the larger firms (Canadian control of production revenue was approximately 10 per cent as of October 1980)
- to increase the share of the oil and gas sector *owned by government* (from 4.7 per cent of production revenue as of October 1980).

The major instruments employed to achieve these objectives are:

- replacement of the earned depletion and superdepletion allowances (delivered through the tax system and of maximum benefit to resource firms already in taxpaying positions) by a system of incentive payments (or PIP grants) for exploration and development expenditures that depend upon the degree of Canadian ownership
- reserve to the Crown a 25 per cent interest in every right on the Canada Lands – the so-called 'back-in' provision
- requirement that a minimum of 50 per cent Canadian ownership –

private or public sector – obtain for any production from the Canada Lands

– government takeover through the Federal Crown Corporation Petrocan of several large foreign-owned firms, together with a standby offer to buy back any foreign firm willing to sell at fair and reasonable prices. (EMR 1980, 42-52)

In discussing the possible benefits of Canadianization it seems to me that there are two sorts of benefits to distinguish. First, there are the real financial benefits that might accrue to Canadians because they own more of an energy sector that is expected to appreciate in value. These benefits are measured in terms of an enhanced flow of privately appropriable goods and services. Second, there are the psychic benefits that might accrue to Canadians from the knowledge that Canadians control more of the energy sector and thus have more influence over the pace and direction of its development.[14]

But unfortunately, and contrary to the NEP presentation of the matter, whatever form the benefits of Canadianization take (and clearly both forms of benefit were anticipated), these benefits do not come at zero cost to Canadians. In fact, there is a significant opportunity cost associated with any investment in Canadianization; it takes the form of a larger externally-held debt and less private investment and consumption than would otherwise occur. But beyond this, if some of the direct costs of Canadianization are incurred by the U.S., Canadians run the risk of having to pay additional costs because of adverse changes in U.S. policies towards Canada. No hint about the complexity of the tradeoff is given to respondents in surveys which reveal overwhelming popular support for Canadianization.

Suppose we begin with the following assumptions:

- that any transfer of ownership leaves exploration, development and production costs unchanged; there is no loss in efficiency
- that the transfer is fair trade, giving the foreign owner at least the present discounted value of his expected after tax earnings
- that private firms receive world prices for oil and gas production
- that expectations about the future course for oil and gas prices and interest rates are the same for buyer and seller
- that private and social rates of discount coincide

– that capital markets are perfect so that Canadians can borrow the funds necessary to finance and investment in Canadianization without impairing present and future consumption possibilities.

It then follows that Canadianization is at best a zero-sum game leaving Canadians no better or worse off in terms of privately appropriable goods and services. The only rationale would have to involve psychic benefits that derive from the knowledge that control is now in Canadian hands rather than in foreign hands. It also follows that there is a fatal flaw in one of the motives given for Canadianization – that it avoids a transfer of rents to foreigners when energy prices rise. Assuming that the transfer of ownership is a fair trade, there can be no Canadian appropriation of the future rents from *anticipated* increases in energy prices without Canadians paying for them fully in advance. Canadians stand to benefit only if future energy price increases are greater than anticipated, and if future interest rates are lower than anticipated.

But producer prices for oil and gas in Canada have both been set below world prices, so the value of oil and gas rights to private firms is less than its worth to society. Suppose a transfer of ownership takes place between a multinational and a Canadian-owned firm, that it is a fair trade, that the two firms are equally efficient, and subject to the same tax treatment. There is a scenario under which Canadians as a whole might benefit; it rests on the proposition that a federal government would be more favourably inclined to adopt world prices for oil and gas in Canada if majority ownership resided at home rather than abroad. If so, the *maximum* net gain to Canadians would equal the present discounted value of the efficiency gain that results when all oil and gas that is less costly to produce than the world price is actually produced.

The problem with this scenario is that it presumes a certain naïvety on the part of the foreign owner. An astute owner would be inclined to capitalize the likelihood of this event into his selling price, knowing that if he does not sell while others do, he stands to benefit when and if world oil prices are adopted. If any of this capitalization takes place, but the anticipated move to world oil prices does not, then the transfer of ownership yields a net economic loss to Canadians. Canadianization looks like a bad bargain if this is its sole rationale.

Suppose that buyers and sellers alike place a zero probability on any move toward world prices when and if majority domestic ownership is achieved. Consider instead the fact that the transfer of ownership is tax induced; it arises because of differential tax treatment which makes oil and gas rights more valuable to Canadians than to foreigners. However, in the scramble to transfer ownership there is no assurance that the more favourable tax treatment offered Canadian-owned firms gets captured by Canadians rather than by foreigners. The distribution of these gains depends upon the relative bargaining positions of the two parties; gains are more likely to be transferred abroad when there are several Canadian buyers confronting few foreign sellers, and when the differential tax treatment is more a subsidy to Canadian ownership than a tax on foreign ownership. In this case both parties would benefit, but Canadians as a whole would lose even if the resources are transferred to equally efficient Canadian-owned firms.

However, the tax system was not neutral to begin with. There was a clear bias in favour of existing firms in tax paying positions over prospective new entrants, and the existing firms were largely foreign-owned. The pre-NEP tax incentives inadvertently created a barrier to entry for new Canadian risk capital. Thus, it is conceivable that the new fiscal system causes a more efficient Canadian firm to replace a less efficient foreign firm. But since the NEP does not restore neutrality and instead replaces one biased fiscal system with another, these efficiency gains are just conceivable, not necessary.

Canadianization is to be achieved, in part, by having the Federal Crown Corporation Petrocan acquire the assets of several of the large foreign firms. Suppose Petrocan is just as efficient as the multinational it buys out, and suppose the takeover is a fair trade that gives the multinational the present discounted value of his expected after-tax earnings. There are two possible reasons why such a takeover could yield a new economic gain to Canadians. First, to the extent that Canadian oil and gas prices are kept below world prices the market value of the oil and gas resources to the firm will tend to be less than their worth to society. Provided that the capitalized value of the difference is not completely transferred to foreigners, a net gain to Canada would occur. Second, it is likely that the supply price of capital for a multinational firm operating in Canada incorporates some private risks that are not social risks (e.g., the risk of punitive tax treatment or nationalization). Then Petrocan could acquire the assets at fair market value and realize a net social gain because the risk premium that enters as a cost of capital to the multinational would disappear from the standpoint of the Crown Corporation, now becoming part of rent.

I do not think that either of these theoretical possibilities translates into potential gains of great quantitative significance, but I could be wrong. As discussed earlier, since foreign firms are well aware of the worth of their assets to Canada they will tend to hold out for this value before selling. A divergence between private and public sector discount rates due to political risk is certainly plausible, but I resist its logical implication that since political risk is unavoidable in a democratic society, public ownership is the ideal solution unless the efficiency costs are high enough. In any case, it seems empirically unlikely that the public sector discount rate is less than the rate at which foreign investors discount their after tax earnings in Canada, for reasons discussed below.

I come now to the final assumption – that Canadianization merely involves an exchange of financial assets and results in no displacement of private investment or consumption in Canada. There is general agreement that the appropriate public sector discount rate for Canada is in the order of 7 to 10 per cent in real terms even though the average cost of external borrowing is in the 4 to 6 per cent range (Burgess 1981; Jenkins 1981). One important corollary of this is that any increase in government borrowing to finance an investment in Canadianization will displace some consumption and investment in Canada.

Under the NEP, any investment in Canadianization by the government through Petrocan is funded by a 'Canadian ownership levy', which is an excise tax on domestic oil and gas consumption. The idea of raising the consumer price of oil to the world level is, of course, widely supported by economists as the best means of discouraging wasteful consumption. But the apparent attractiveness of the method of financing should not be allowed to influence the basic wisdom of the policy itself. The revenue from an excise tax on domestic oil and gas consumption could be used to reduce the overall public sector deficit rather than to finance an investment in Canadianization. Therefore, the appropriate discount rate for evaluating the Canadianization policy is the same as for any other public investment decision – the rate of return forgone in the private sector when resources are shifted into the public sector.

Insofar as private sector investments in Canadianization are concerned, it seems virtually certain that the tax-induced takeovers have come at least partially at the expense of other investments that these firms would otherwise have undertaken. But even if Canadianization involved simply a change in the composition of international indebtedness – an exchange of debt for equity – one can expect an adverse effect on the measured balance of payments since the annual interest payments on debt typically exceed the annual dividend payments on equity. A current account deficit that is larger than it otherwise would be will lead to tighter monetary conditions and result in some displacement of private consumption and investment in Canada. Whatever dampening of economic activity that occurs as a consequence of Canadianization must also be included as part of the cost.

While I think that for the most part all of the costs of Canadianization are incurred by Canadians, it is worth considering the nature of U.S. objections to Canadianization to see if some of the costs are in fact shifted to the U.S. The U.S. has consistently maintained that the goals of Canadianization are not at issue, just the methods used. The two aspects of Canadianization of greatest concern to the U.S. are: first, the fact that the incentive payments for exploration and development violate the principle of national treatment, and bring into question Canada's commitment to a free and open international trading system; and second, that the 25 per cent 'back-in' provision for all production on Canada Lands changes the rules in the middle of the game and therefore amounts to expropriation without compensation. To the extent that either of these arguments has merit – or is perceived to have merit – in the U.S., Canada runs the risk of U.S. policy reactions that would lower Canadian real incomes.

But the absence of explicit retaliatory action by the U.S. government does not suffice to ensure that Canadians pay no additional costs. Unless Canadianization is seen by foreign firms to be at zero cost to them, the policy may further increase the risk-adjusted supply price of capital for all foreign firms not bought out. Not only will this further dissipate potential rents to be captured in the energy sector, but it will also deter beneficial direct investment in other sectors of the economy.[15]

The Canadian government is evidently gambling that the U.S. government will recognize that retaliatory actions are likely to reinforce Canadian attitudes about the extent of U.S. power and influence in Canada, and therefore be counterproductive. Also, from the standpoint of the U.S. government the Canadianization experiment may be seen as desirable if the transactions are at fair market value, since if U.S. direct investment is encouraged to return home it benefits U.S. labour as well as the U.S. economy as a whole under present international tax arrangements. On the matter of discriminatory treatment and changing of the rules, Canada has acknowledged, to an extent, the validity of the U.S. position. The Canadian response has been that discriminatory treatment was necessary to achieve greater private sector participation in a unique and strategic sector of the economy, and that a changing of the rules was necessary because the rules were vague, incomplete, and inappropriate and they were having unforeseen side effects. But Canada also maintains that U.S. interests have not been hurt by Canadianization. Thus, while Canadian-owned firms do receive richer incentives than foreign firms this does *not* reduce the value of existing U.S. investments in Canada but rather tends to enhance them, because Canadians are being encouraged through tax incentives to pay premium prices for them. Second, the incentive grants do *not* exclude U.S. firms from the most promising exploration sites; the most promising sites are already in U.S. hands, and have been since the 1960s. Third, U.S. firms are *not* precluded from participation on Canada Lands; they are encouraged to proceed in joint ventures with Canadian firms rather than with other multinationals. Fourth, the 25 per cent carried interest provision is *not* regarded as a radical departure from the pre-NEP fiscal regime, but rather a rationalization of a land reversion concept that was already entrenched in the Canada Lands exploration process; it is not viewed as confiscatory or retroactive any more than a windfall profits tax is.

I have only a few general conclusions to draw from all of this. I would claim that the notion that Canadianization could somehow yield a net financial gain to Canadians as a whole is, for the most part, wishful thinking. Canadianization could prove to be a wise policy, but it requires that interest rates be lower than expected and energy prices be higher than expected, and this prospect now seems like extremely long odds. Instead, most of the benefits are likely to be of the public goods variety, flowing from the knowledge that more control over the pace and direction of oil and gas development resides at home rather than abroad. These benefits may be quite substantial, but they are extremely difficult to identify and measure and in any case they are purchased at considerable cost in terms of the real income of the average Canadian. And while such benefits will undoubtedly be very important to some, they are unlikely to be very evenly distributed; 'nationalism is a public good consumed by nationals', as Harry Johnson once remarked.

Canada's long-standing resistance towards trade liberalization suggests that most Canadians are prepared to sacrifice some real income to preserve a sense of identity distinct from the U.S.; and Canada's legitimate right to pursue nationalistic objectives cannot be questioned. But a clearer perception of the costs of doing so seems crucial before attempting to reduce the foreign ownership and control figures by additional percentage points. There is scant evidence that the Canadian government fully comprehended the nature of the tradeoff between Canadianization and other frequently espoused objectives – oil self-sufficiency by 1990, a revitalized manufacturing sector, smaller federal deficit, etc. But the fundamental fact is that the funding for any investment in Canadianization must either absorb domestic savings, displace other private investments, or increase Canada's international indebtedness. It seems to me to be crucial to consider carefully whether additional investments in Canadianization make the best use of these scarce and costly resources.

Given Canada's stake in a free and open international trading system Canada must be especially sensitive to the need to pay the full price for Canadianization and not to shift any of its costs on its trading partners either deliberately or inadvertently. While I believe that U.S. reaction to the 25 per cent Crown interest provision was excessive and rhetorical (e.g., the persistent reference to the 'back-in'), to some extent it may have reflected a genuine misunderstanding about the different treatment of mineral rights in the two countries. In the U.S., mineral rights are sold at auction giving developers proprietary rights; in Canada they remain the property of the Crown and are only leased out to those who want to explore on them for set periods, after which they revert to the Crown which can establish whatever conditions it feels appropriate (Clarkson 1983, 37). In any event, the time for the U.S. to have objected to the Crown interest provision was in the mid-1970s when it was first clearly spelled out and applied, and not when the NEP was introduced.[16] Nonetheless, the provision has been altered so that the Crown now makes an *ex gratia* payment for pre-1981 expenditures on a field declared significant by 1983 and which was first drilled before 1981. However, since the main objective of the provision was to ensure that a greater share of oil and gas revenues accrue to Canadians, a preferable alternative would have been for Canada to raise the progressive incremental royalty rate. Such a move would have reduced the potential damage of Canadianization on Canada/U.S. relations.

NOTES

1 Since many of Canada's energy using sectors are also foreign-owned the present cheap oil policy may well subsidize the returns to foreign-owned factors of production employed in these sectors and/or subsidize foreign consumers of Canadian exports of these goods through lower prices. However, to the extent that Canada is a price taker in these markets and to the extent that the cost of capital is highly elastic to these sectors, the main effect of the cheap oil policy will be to raise real wages in Canada, implying that most of the benefits will accrue to domestics rather than to foreigners.

2 A newly elected government might observe that a two-price system for oil tends to encourage high-cost sources to be developed first and tends to distort investment decisions away from the use of conventional methods toward enhanced recovery techniques. The result is higher overall recovery costs and some dissipation of potential economic rent.

3 However, as I explain later, if an increase in the price of conventional old oil to the world level were combined with a move towards free market prices for natural gas the perverse distributive effects would be minimized.

4 A good recent overview of Canada's energy trade patterns and the issues that emerge from them is found in External Affairs Canada 1983, 80-93.

5 For good reviews and analysis of Canada's oil trade relations with the U.S. see James McKie 1979 and Waverman 1974.

6 See Clarkson 1983 for an example of this misinterpretation.

7 I am indebted to two papers by John Helliwell for developing my perspective on natural-gas trade. See J. Helliwell 1979 and 1980.

8 The Borden Commission has also recommended that 'due to accepted principles of pipeline financing and possible delays in construction it appears to be necessary to grant export licences for a period somewhat larger than 20 years'.

9 For a good review of the details of the 1979 and 1983 NEB export decisions see Canadian Energy Research Institute 1983, 43-8.

10 For a comprehensive statement of current NEB surplus determination procedures see National Energy Board 1983.

11 The Borden Commission had recommended in 1958 that natural gas export contracts 'should contain fair and reasonable provisions for price adjustments during the term of the contract, so that the exporter and in turn the gas producers, will participate in any benefits accruing from general price increases occurring in export markets'.

12 For a good overview of the issues see Energy, Mines and Resources (1982b).

13 See letter of 27 November 1981 from Professor R.G. Lipsey to Mr. Paul Burke (Ontario Hydro), 2.

14 There are also certain spillover benefits that might flow to Canadians with greater Canadian control. Thus, Canadians may be denied access to the spinoffs from energy resource development even if they can provide a competitive service, if multinationals have biased procurement policies. It seems to me that these benefits can best be captured by other methods.

15 The federal government evidently realized this possibility *ex post* since it firmly announced in a subsequent policy statement that there would be no Canadianization of other sectors of the economy. See Government of Canada 1981.

16 The industry was put on notice as early as 1976 that the terms and conditions for production on the Canada Lands would be restructured. See Energy, Mines, and Resources Canada 1976.

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Comments

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In discussing the role of the National Energy Program in Canada within the wider set of trade and investment issues which currently characterize Canada/U.S. relations, it is important to keep in mind both the objectives and the effects of the National Energy Program (NEP). The NEP is part of a wider pattern which seems to characterize other Canada/U.S. trade and investment issues, namely the desire by Canadians to follow domestic policies which are viewed in Canada as purely domestic matters, while in fact these policies have international implications which fall primarily on the U.S. because of its importance as Canada's largest trading partner.

What then are the objectives of the NEP and how do these relate to the wider trade and investment issues between the U.S. and Canada? As is by now well-known, the NEP has its origins in the policies adopted in the mid-1970s to insulate Canada from the impacts of the rise in world oil prices due to OPEC. Three different objectives characterize the present program.

A made-in-Canada price

Under the NEP, domestic prices of both oil and natural gas have been controlled below world levels to allow for a slow adjustment towards elevated world prices. This objective has its origins partly in regional conflicts within Canada, since producers and consumers within Canada are spatially separated. The Liberal government was returned to power in 1980 on the platform of not introducing the increase in the excise tax on gasoline which had been promised by the defeated government, a platform politically popular in central Canada. Under the made-in-Canada price, Canada was to set its own producer prices for oil leading to the blended price features of the National Energy Program.

Self-sufficiency

A made-in-Canada price inevitably involves a set of controlled prices below world prices which has disincentive effects on energy supply. This is in conflict with the second objective of the NEP, namely self-sufficiency in energy supply. While the first objective of NEP is to insulate Canada from developments abroad and particularly the effects of OPEC on world oil markets, a second objective is self-sufficiency (originally targeted by 1990). This requires stimulating new sources of energy supply, leading to the exploration grants and the PIP incentive program under NEP.

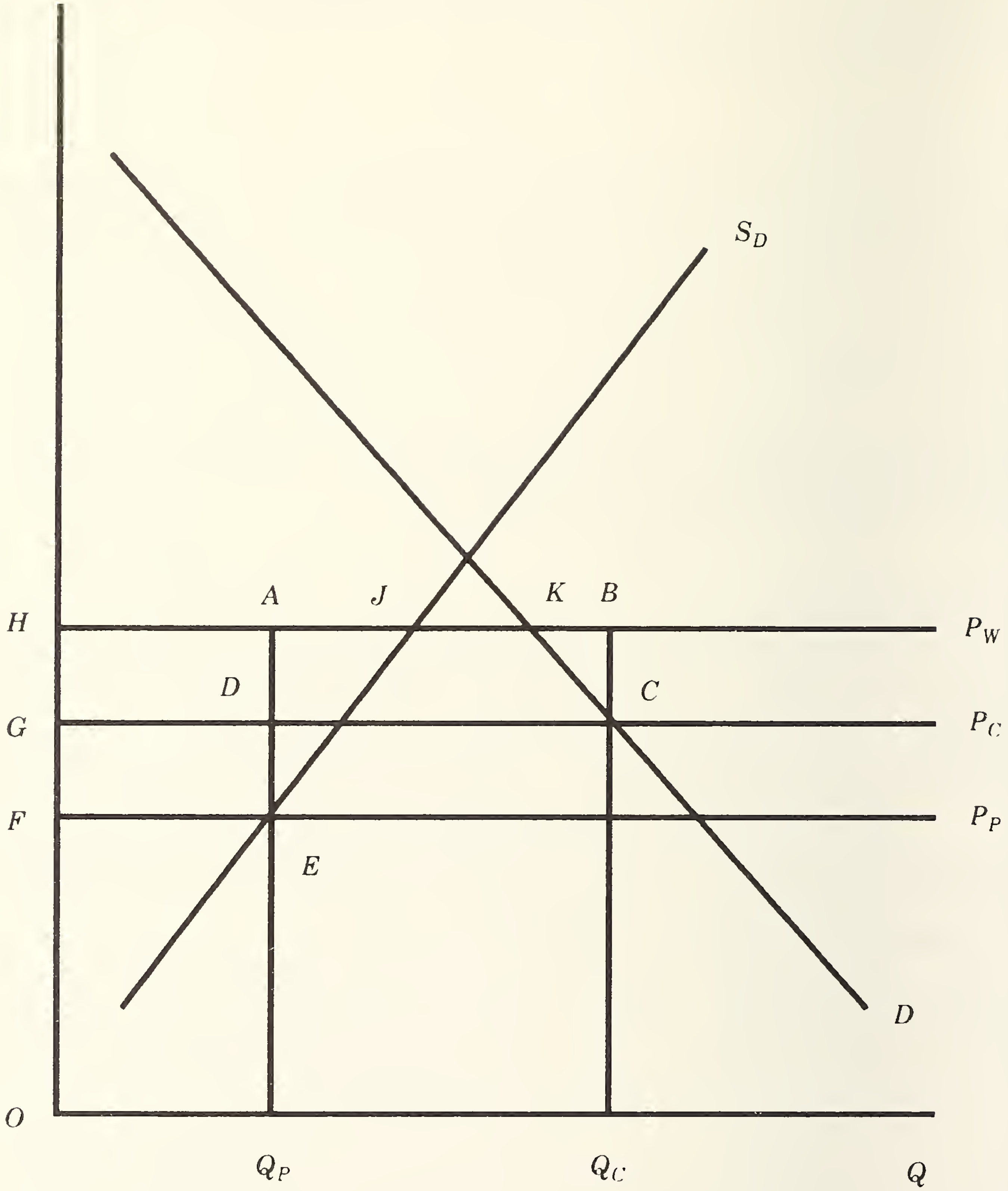
Canadianization

The third objective of NEP – Canadianization of the energy industry, is part of a wider set of objectives stemming from the upsurge of economic nationalism in Canada in the 1960s. Increased Canadianization under NEP is to be achieved both through takeovers of foreign subsidiary companies financed through the Canadianization levy charge, and through conditional features of the PIP incentive program which relate the size of incentive payment to the degree of Canadian ownership.

How then do these objectives translate into net effects on the economy? The major effect of the price control elements within the NEP is clearly to transfer rents from producers to consumers. This is indicated in Figure 1 for the case of oil, where the demand and supply in Canada is represented along with the world supply function at a fixed world price. S_D indicates the domestic supply function of oil in Canada, and D designates the domestic demand function. The effect of controlling prices below world prices, at P_C for consumers and P_P for producers, is that Q_P is the quantity produced in the presence of the producer price controls and Q_C is the quantity consumed under the consumer price controls.

The requirement for a made-in-Canada price produces differential consumer and producer prices because of the necessity to subsidize

FIGURE 1
Effects of NEP price controls on oil



imported oil down to domestic prices. The area *ABCD* represents the oil import subsidy and the area *GDEF* additional taxes on producers to pay for oil import subsidies. The area *HJEF* represents the transfer from producers. The area *HKCG* represents the gain to consumers from the program.

From an international point of view the issue is how much of the transfer from producers is a transfer from foreign owners of oil? To the extent that a transfer of rents from foreigners to Canadians occurs under the National Energy Program, U.S. interests (in particular) are adversely affected by NEP. Surprisingly, the major source of international friction which the NEP has generated has not been due to the rent transfer stemming from the price controls, but the 'back-in' provisions which involved changes in the leasing arrangements on Crown land. From a Canadian point of view, this latter issue seems to have been an unnecessary conflict since the same effect could, for instance, have been achieved through tax policy.

Thus, from a Canadian point of view, a key lesson seems to be indicated from experience with the NEP, namely that it is often possible to achieve Canadian interests without inflaming U.S. passions through more careful policy design. Although at first sight it may seem that Canadian policy objectives and U.S. interests are diametrically opposed, the main response from the U.S. in this case has involved only a small aspect of the wider program, namely the change in the 'back-in' provisions rather than a wholesale rejection of the program itself.

Issues in Canada/U.S. energy trade and investment: a U.S. perspective

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First, I would like to express my pleasure at being here in one of Canada's most attractive cities, London, addressing this outstanding workshop program at the University of Western Ontario. Twenty years ago, I spent a month in London, in charge of a geophysical crew for one of my previous employers. Despite my best efforts, London does not yet rival Calgary or Houston as an 'oil town', but I'm not sure that London is any the loser for that.

Energy trade and energy investment – especially, foreign energy investment – have become politically sensitized the world over this past decade. Thus, it is no surprise that this area of commerce generates its share of friction between the United States and Canada. However, when political friction intervenes in otherwise free and open exchange between nations, it imposes inefficiencies and deadweight costs on all the parties involved. In spite of our individual biases, I think all of here would all agree that careful analysis of these inefficiencies and costs can lead (at least, directionally) to improved policies that yield positive benefits. Workshops such as this can stimulate this process of policy analysis among professional economists, and I would like to commend the workshop organizers and the Universities of Western Ontario and Michigan for their outstanding efforts in putting together this weekend's program here at Western.

My perspectives on these policy issues are those of an economist who has spent much of the last decade wrestling with government policies – mostly those of the U.S. federal government – that change economic behaviour in the energy marketplace. I cheerfully confess to a strong preference for the economic institutions of the free, competitive marketplace rather than those of a statist, command economy. This is based not only on a personal preference for free institutions, but also on years of observing the dismal results of most statist economic systems.

Also, while I am an economist by both vocation and avocation, I don't conceal the fact that my principal employer is an oil company: indeed, an American oil company. I believe that one good way to learn the economics of an industry is to work in it for twenty years. However, I am not here as any sort of official spokesman for my employer, Standard Oil Company (Indiana).

Before I proceed, I would like to acknowledge a particular debt to Professors David Burgess and John Whalley of the University of Western Ontario for their very stimulating presentation of the Canadian perspective at this workshop, which has been of invaluable help in forcing me to rethink and reword my final comments. No blame of any sort should be laid to them, of course, or to any of the other workshop participants for the views expressed in this paper.

CANADA/U.S. ENERGY TRADE: AN OVERVIEW

Energy trade between Canada and the United States includes back-and-forth flows of crude oil, refined products, coal, and electricity at various places along our long common border. In net terms, Canada is an exporter of natural gas, oil, and electricity, while the U.S. is a net exporter of coal. This energy trade shows an annual export balance on the Canadian ledgers of some $3 U.S. billion.

While both of our countries impose restrictions on energy trade, I suspect that even if completely free trade in energy was permitted between our nations, the existing pattern of energy logistics would only be altered slightly. Despite some remaining economic inefficiencies of the 'coals to Newcastle' variety incurred in restricting this trade, it is overwhelmingly beneficial to both countries. I believe current friction in Canada/U.S. energy trade is less over the dimensions of the trade flows than over the terms which determine the bilateral distribution of the gains from this trade.

Canadian natural gas exports to the United States

I plan to concentrate my comments on energy trade between our two countries on its biggest dollar component, the export of natural gas from Canada to the United States. This gas trade offers great potential for expansion, but may also become a continuing source of energy trade friction between our countries if we are not both guided by the common sense realization that while we can both gain from trade, we can also both lose. There are two major issues: first, near-term problems in marketing Canadian gas in the United States, and second, long-term prospects for growth of this trade and its implications for future gas developments in Canada.

The current issue: gas bubbles and gas prices

The immediate gas export problem has two aspects. First, the United States now finds itself with more domestic gas production available than gas users are willing to buy at the prices currently charged by the regulated natural gas pipeline industry. This shut-in component of domestic supply amounts to some 15 per cent of current U.S. consumption.

This gas 'bubble' is partly the result of modest increases in domestic productive capacity, a severe recession, two successive warm winters, and some price-induced energy conservation. It also reflects a highly regulated marketplace where the prices charged by regulated gas utilities have risen steadily in the face of two years of declining demand and declining competitive prices of other fuels, especially oil. This has lead to fuel-switching, especially in the industrial fuel market where gas competes with residual fuel oil.

The bubble is thought to be a transient phenomenon. It is expected to disappear within two to four years assuming normal field production declines, the pickup in demand expected in the course of the economic recovery, and a positive move towards establishing a more competitive, deregulated pricing environment for the U.S. gas industry. In the interim, few U.S. gas pipelines are shopping for new gas supplies, but are instead trying hard to get out of some of the supply contracts they executed in recent years. It is thus no surprise that Canada is experiencing a decline in gas exports to the U.S., and itself faces a 'bubble' of excess gas deliverability in the western producing provinces.

The excess gas supply situation in the United States is inextricably tied up with one of the fundamental problems with the U.S. natural gas market, namely, the system of wellhead price controls enacted in the Natural Gas Policy Act (NGPA) of 1978. No matter how harsh the

Canadians here may find my remarks about Canada's National Energy Plan later in this paper, I would assure them that the American NGPA probably deserves even higher marks for destructive interventionism and Byzantine complexity.

Several competing bills to repeal or modify the NGPA are now before the U.S. Congress. It is uncertain how or when this legislative effort will yield results, but in spite of this, competitive market forces are becoming very evident in the American gas industry. The market is signalling that the unique regulatory circumstances that precipitated some gas pipelines into bidding up to three times the marginal fuel-equivalent value for NGPA-exempt gas supplies as recently as two years ago are no longer valid.

Imported gas is also exempt from NGPA controls: thus, those same unique circumstances led the U.S. Department of Energy in the late seventies to agree to a border pricing formula for gas imports from Canada and Mexico that was the envy of U.S. gas producers. You may conclude that the market is also telling us that this border pricing system, just like the NGPA itself, is out of touch with the competitive realities of the natural gas business.

These competitive market forces are deriving much of their impetus from interfuel competition in the industrial energy market. About half the total gas used in the United States is burned under boilers and process units in electric generating plants and industrial facilities. Much of this gas is sold on an interruptible basis, whereby the supplier can divert the gas to other customers if a better market opportunity arises. About half of this boiler fuel market for gas is found along the U.S. Gulf coast, where gas competes directly with residual fuel oil that currently sells for roughly $U.S. 3.50 per MMBtu ($Cdn. 4.55 per GJ). On a fuel-equivalent basis, this nets back to a wellhead gas price of substantially less than $U.S. 3.00 per Mcf ($Cdn 138 per thousand cubic meters), and represents a *de facto* competitive equilibrium price. If there is excess demand for gas in other market sectors at prices above Gulf Coast boiler fuel equivalence, gas supplies from the Gulf Coast can move through the extensive U.S. pipeline network and restore price equilibrium. Thus, the prospects for sustaining a higher competitive market price for gas at the wellhead are poor. Evidence of this is provided by recent U.S. Energy Information Administration data which show that average wellhead gas prices in the United States have actually levelled off in the vicinity of $U.S. 2.60 per Mcf in the first half of this year, after moving up 40 cents during 1982.

This dreary digression into the mechanics of the U.S. gas market may, for many of you, fall into the category of 'more than you wanted to know' on the subject, but the U.S. regulatory situation has obvious implications for Canadian gas exports. In the traditional export market areas for Canadian gas (i.e., the upper midwestern states), it is hard to see how a competitive U.S. pipeline company could be enthusiastic about paying more for Canadian gas at the border than it can sell the gas for in the marginal market for boiler fuel. Even after adjusting for transportation differentials, this price is far below Canada's current base-volume border price of $U.S. 4.40 per MMBtu, and even below the recently-introduced incremental price of $U.S. 3.40 per MMBtu for increased sales volumes. As a back-of-the-envelope guess, I would imagine that serious trading interest will not soon develop at prices above $U.S. 3.00 per MMBtu.

I realize that in October of this year, Canada's Energy Minister, the Hon. Jean Chrétien, offered the view in New York that 'The availability of a long-term supply source from a friendly and stable country has got to be worth something to the American consumer'[2] Lingering American fears about Canadian stability and friendliness in energy matters were not allayed by the Hon. Mr. Chrétien's subsequent dark hints that Canadian gas 'might not always be there.'

Neither Canada nor the United States is going to yield to veiled threats over gas supplies. A majority of Americans also regard Texas, Louisiana, and Oklahoma as friendly, and gas producers in these and other states are not being paid a premium for stability. Natural gas trade between our two nations will thrive, however, if we can both begin to look at it as 99 per cent good commercial business and less than 1 per cent international politics, and not the reverse.

There is some perception in Canada that the current gas market situation in the United States is unique, and that the peculiar U.S. regulatory environment will again allow Canada to command a premium price once the gas 'bubble' problem eases. I wouldn't count on it. Bubble or no bubble, the forces of interfuel competition have taken hold in the U.S. gas market, and they aren't going to disappear. Long-term contracts often command a slightly higher price than spot transactions, but these differentials are slim and competitively determined. The only feature of the current gas export pricing situation which could be deemed unique is the basic pricing formula itself, which reflects the extraordinary gas market situation of 1979, where Canadian exports sold at a premium in the United States because they were exempt from NGPA controls.

In some circumstances, Canada may again be able to command a premium export price for small volumes of gas in future years should sporadic, critical gas shortages arise in the United States, or should U.S. pipelines require extra peak-saving gas in the winter. These may appear to be tempting prospects, but they are not. Isolated opportunities to earn high spot prices in a crisis can never support the investment base of a gas export industry, especially when domestic and export markets both peak in the same seasonal demand period.

Behind the scenes, it is apparent that the Canadian government is taking a pragmatic, wait-and-see approach to gas export policy, at least until the outcome of the price control debate in the U.S. Congress is resolved one way or another. This may be some time in coming, as the issue is politically sensitive and 1984 is an election year.

In the interim, the Canadian strategy probably incurs close to zero opportunity cost, as there is little practical chance of either side making the concessions needed to substantially expand gas export sales in the next few months. The potential for increasing gas exports into a more competitive U.S. gas market at substantially lower border prices may force some rethinking on the part of Ottawa and the producing provinces regarding export expansion, as well as on both export and internal gas pricing policies. In regard to the latter, the Alberta Energy Minister, Hon. John Zaozirny, has stated that the Alberta government hopes to see a switch to market pricing of exports by next fall.[3] This outcome could require both levels of government to revamp their tax and royalty regimes if Canadian producer netbacks are to remain sufficient to attract further investment.

Long-term potential for gas exports

Looking into the next decade, it is widely accepted among geologists and resource economists that the conventional natural gas resource base in the lower 48 states of the U.S. is not likely to be able to sustain continued depletion at current rates of approximately 20 Tcf per year. (1 Tcf of gas = 1.08 EJ). The specific dimensions of this decline in production capacity are uncertain, as they hinge on arguable technical questions plus assumptions about the impact of anticipated regulatory changes on producer incentives. Nevertheless, there is some consensus that there may be a market opportunity in the United States in the nineties for some one to four Tcf per year of additional natural gas or some close substitute. Several possibilities loom on the horizon, each with its own set of prospects and problems: increased gas imports from Canada, or Mexico, or both; tanker imports of liquefied natural gas (LNG) from overseas producers; gas from Alaska, via pipeline or LNG tanker; synthetic gas from coal; so-called 'unconventional' domestic gas sources; or gas displaced from under boilers by coal, nuclear fuel, or imported oil.

If this opportunity were available today, Canada would be in a strong competitive position. Mexico faces financial constraints on several fronts, and investments in new pipelines to move gas from southern Mexico to serve the United States market may rate a lower priority for funding. The other potential supply sources all face problems: very high economic costs in the case of Alaskan pipeline gas, LNG, synthetic gas, and unconventional gas resources, plus some difficult political barriers in the case of increased use of nuclear fuel or increasing oil imports. And I need not go into the environmental implications of increased coal burning in the United States before a group of eastern Canadians.

It is not at all certain that Canada will enjoy the same competitive economic advantage in gas exports ten and more years from now that it enjoys today. The problem is not one of physical resource limitations. Canada has more than enough gas in its traditional production areas to meet its needs for over thirty years. New reserve additions have, at least until recently, exceeded current production, and Canada is also proving up large potential gas resources in its 'frontier' Arctic and Atlantic offshore areas. Instead, the real concern over the long-term availability of large volumes of gas for export is related to the man-made economic climate for investment in new gas supply projects.

Will Canada decide to seek this emerging export opportunity, or will the resources be left untapped for some future generation? If the former course is chosen, will the rate of investment in the Canadian gas industry over the next decade be sufficient to provide for both domestic needs and this expansion in export capacity? To paraphrase Mr. Chrétien, the U.S. market opportunity may not always be there, either.

INVESTMENT POLICIES

The question of future gas exports leads us into the question of energy investment policy. The problems in this area are both a 'here and now' issue and a future issue. From what I have read regarding your workshop in Ann Arbor last April, the specifics of Canada's National Energy Program (NEP) and Foreign Investment Review Agency (FIRA) were examined in detail. I have no wish to rehash all those proceedings with you here. However, I would like to take a brief look at what the NEP, in particular, has accomplished, and what its future implications appear to be for investment – both foreign and domestic – in the Canadian oil and gas producing industry.

Other participants in this workshop have critiqued the FIRA at some length, so I will not devote any time to it. This is not that I approve of the FIRA – it is obviously protectionist. But the problems and irritations which the FIRA causes for foreign energy investors are clearly overshadowed by the grave deterioration in the Canadian oil and gas investment climate brought about by the National Energy Program.

The National Energy Program: general goals

At first glance, the stated goals of the NEP are innocuous enough:

- Greater participation by Canadians in the petroleum industry;
- Wider distribution of the benefits of resource development; and
- Achieving 'energy security' for Canada by 1990.

These goals don't look much different from those which Americans have been offered in Presidential Energy Messages on several occasions since the Nixon administration first launched 'Project Independence' in the wake of the 1973/4 OPEC embargo. It is difficult to argue that a proud and independent nation like Canada should not set out an energy policy agenda which, at face value, appears to focus on modest increases in participation by the Canadian people, accelerated domestic resource development, and achieving greater energy security.

In its implementation, however, the NEP has been controversial, particularly in the western producing provinces and in the United States. The leading publication of the American petroleum industry, the *Oil and Gas Journal*, editorialized when the NEP was first announced that Prime Minister Trudeau had chosen the worst parts of the worst energy policies of the United States, the United Kingdom, and Norway (among others) in designing the program.[4] The NEP and FIRA were the subject of extensive hearings in Congress in 1981 before Michigan Congressman John Dingell's House Committee on Energy and Commerce,[5] and the tone was not friendly.

Canadians can argue, of course, that Canada has the sovereign right to adopt any energy policy it chooses, even a bad one, and it's none of the business of the United States Congress or anyone else, including the *Oil and Gas Journal*. But the effects of Canada's policies go far beyond its borders, so it is no surprise that many in the United States still harbour strong opinions on the NEP. At the government policy level, the NEP is of concern to the United States, as both our countries are signatories to the International Energy Agreement. Given the mutual assistance provisions of that document, all participating countries have legitimate concerns about the internal energy policies adopted by their partners. Also, both our nations have accepted in principle the concept of fair and neutral treatment of foreign investment, and the U.S. government has openly stated its view that several features of Canada's NEP and FIRA are in violation of that principle.

More fundamentally, it is hardly a secret that foreigners have an enormous presence in the Canadian oil and gas industry, and economic policies that discriminate against the oil and gas industry discriminate *de facto* against foreign investment.

The foreign presence in the Canadian oil and gas industry can be expressed in invested dollars – something like 20 billion Canadian dollars as a round number. These investments are private property, paid for by Americans and other foreigners who, in good faith, invested their funds in Canada in full accordance with Canadian laws in effect at the time. Canadians had fully equivalent opportunities to invest their own funds in the oil and gas industry also, and while some of them did with great success, many apparently chose not to. It is only natural that Americans should be concerned about their property rights in Canada, just as much as Canadians should be concerned about their very considerable private property rights in the United States. Thus, I believe the 'none of your business' defense of the NEP is more worthy of a totalitarian banana republic than of a stable, developed nation like Canada with its far-reaching external relationships and a long, honourable tradition of living up to its commitments.

It is three years now since the outlines of the NEP were first sketched out in the Canadian budget message. I believe it is worthwhile looking at some of the results the NEP has produced during that time. I am going to focus on selected aspects of the NEP which impact noticeably on U.S. investment in the Canadian oil and gas producing industry. There are a number of other aspects of the NEP that while important, are primarily of internal interest to Canadians – for instance, its part in changing federal/provincial fiscal relationships, and its role in fostering the growth of the state oil company, Petro-Canada – that I will not attempt to analyse here.

Canadianization, phase one: the takeovers of 1981

Much initial American concern over the NEP was focused on its target of achieving fifty per cent Canadian ownership and control of the oil and gas industry by 1990. The NEP specifically identified the outright purchase of foreign oil companies as one way to reach this goal. In 1981, there were a number of aggressive takeover bids made by Canadians for foreign oil firms in Canada.

Takeover bids were not invented by Canadians, of course, and it is common for them to trigger vigorous legal and public relations contests no matter who is involved. As long as a bid is an arm's-length offer made in a competitive market setting, with no coercion exerted on either side, it is hard to view it as a grave matter of national policy.

The 1981 takeover bids in Canada did not, however, fully measure up to the standards of the competitive, open market. The price, tax, and Canadian ownership rules set forth in the NEP had clearly damaged the expected economic value of foreign petroleum assets in Canada, and the market discounted them accordingly. Because of the NEP and FIRA, nonCanadian bidders could not make competing counter-offers. And while the NEP didn't explicitly coerce anyone into selling his shares, foreign investors saw the handwriting on the wall.

Some Americans also expressed dismay that the Canadian banks financing the bids were not subject to the margin rules of the U.S. Federal Reserve Board. This curiously extraterritorial view of Canada as a sort of Thirteenth Federal Reserve District enlisted little support in the United States, I'm happy to say.

In retrospect, while these Canadian takeovers in 1981 may not have met all the normal market standards of fair dealing, the issue is largely moot today. At the time of the takeovers, the world price of oil was at an all-time high, and the perception was that real oil prices were going to keep on going up more or less indefinitely at the real rate of interest, i.e., something like a two to four per cent annual rate. Since those heady days of early 1981, the real price of oil has fallen 35 per cent, and in 1983, an 'optimistic' oil price forecast is one that calls for no further declines. So while there probably is some residual foreign resentment over the takeovers, the sellers can derive comfort from the fact that they effectively sold their oil reserves at 1981 prices. Some of the Canadian acquirers are now suffering from a bad case of energy loan overextension, and find their plans to expand oil and gas investment jeopardized by pressing debt service problems.

Canadianization today: 'Canada-landization' of the oil industry

The Canadianization aspects of the NEP move ahead today via restrictions on foreign ownership of mineral leases on 'Canada' lands (generally, federal lands in the north, the Arctic, and offshore Canada), and via the complex NEP fiscal package of continued price controls, onerous taxes, Canadian ownership charges, and subsidies that artificially tilt exploration and drilling incentives towards the Canada lands. The net result is clearly discriminatory to American and other foreign petroleum firms. Even more importantly for Canadians, these provisions have distorted the incentives against Canadian firms who engage in the oil and gas business in the traditional producing provinces like Alberta. Some of these totally Canadian oil companies are now finding it is more attractive to risk their funds south of the border in the U.S. oil and gas industry. Normally, Canada's federal/provincial political disputes are only of passing interest to Americans, but in this instance, there are several billion dollars worth of American (and Canadian) petroleum investments in the western provinces held hostage to this wasteful policy that encourages the displacement of inexpensive sources of supply by costly ones.

A policy of encouraging exploration on Canada lands by Canadians may have looked like a good gamble in 1980 when there were optimistic projections of 1990 oil prices hitting $U.S. 50 a barrel in 1980 dollars. The common view was that the geologic potential of the

Canada lands looked attractive, and while operating costs might be high, real oil prices would soon catch up and make the most far-fetched undertaking look economic. (To be fair to Canada, that rosy, 1980/81 view of world oil prices got a lot of people besides Canadians into financial difficulties.)

Today it is doubtful that very many of these frontier projects are economically viable at current world oil prices (or equivalent gas prices). The odds also don't look good for another quantum leap in world oil prices bailing them out soon. Nevertheless, the Canadian government continues to dissipate a good share of the taxes it extracts from current oil and gas production on subsidizing drilling in the frontier via Petroleum Incentive Program, or 'PIP' grants. The effect of these incentives on redirecting exploration spending in Canada over the last two years is quite marked, as can be seen from the exploration spending data in Table 1.

In just two years, 1980 to 1982, exploratory spending in the provinces has fallen by 47 per cent (in nominal Canadian dollars), while expenditures in the Canada lands have gone up 97 per cent. Obviously, the PIP program is pushing Canadian exploration into the high-cost frontier and away from lower-cost provincial areas. By function, total leading-edge, predrilling outlays (geological, geophysical, and land acquisition) have fallen by half in just two years. Total drilling expenditures in Canada have fallen by just 2 per cent, however.

This functional breakdown is significant. Efficient exploration must take into account the relative cost of different resource inputs. Among other things, there has to be a reasonable economic balance between basic exploration and actual drilling, yet Canada seems to be on a drilling binge. Reports now are that total Canadian oil industry activity is now on the upswing after two years in the doldrums. However, when you look at actual first-half 1983 well completions, you find that while development drilling (drilling to accelerate the exploitation of reserves already found) is up 36 per cent over last year, exploratory wells are down by 6 per cent. Since 1980, exploratory well completions in Canada are down by 42 per cent. By comparison, 1983 exploratory completions in the United States will run about 15 per cent ahead of the 1980 rate.

Thus, the picture is emerging of the Canadian oil and gas industry as one where exploration is being force-fed in the high cost frontier but

TABLE 1
Cash exploration spending, Canadian petroleum industry, $Cdn. millions

	Predrilling		Drilling		Total exploration	
Year	Prov.	Cdn. land	Prov.	Cdn. land	Prov.	Cdn. land
1974	346	113	196	258	542	309
1975	366	126	187	223	553	349
1976	516	103	309	249	825	352
1977	1,135	79	482	302	1,617	381
1978	1,447	70	794	444	2,241	514
1979	1,896	60	1,263	578	3,159	638
1980	2,153	109	2,006	700	4,159	809
1981	1,317	142	1,801	1,071	3,118	1,213
1982	964	167	1,245	1,426	2,209	1,593

SOURCE: Canadian Petroleum Association, *Statistical Handbook*. Outlays for 'predrilling' include geological, geophysical, and land costs. Outlays do not include PIP grants.

languishing elsewhere. Thanks to the generosity of Ottawa and its PIP grants, drilling is very active, but much of total Canadian activity appears to be directed to developing resources that have already been found, rather than finding new resources. The irony of this is that Canadian taxpayers' money is being used to buy a more costly domestic energy industry. Thus, Canadians are paying twice. Can this setting provide stable, healthy growth for Canada's oil industry?

The 1980-3 situation in Canada has parallels with the energy policy situation that existed in the United States from roughly 1975 to 1980. In particular, the prevailing wisdom was that bureaucrats in Washington, not geologists in Houston, knew where future energy supplies were going to come from.[6] It became an article of faith that the conventional oil and gas industry was all washed up in the United States[7], and the only solution was to pour billions of dollars of taxpayers' money into costly synthetic fuels schemes and to build a gas pipeline from Alaska.

It was also decided in Washington that some additional gas was available if you drilled deep enough – below 15,000 feet – but that because such gas would be extraordinarily costly, it should be exempted from NGPA wellhead price controls. The result of this exemption, of course, was the now-infamous deep-gas drilling binge in the United States. It was driven by an incentive system that rewarded the discovery of costly, not cheap, gas resources. Bankers, relying on the same kind of oil price forecasts that I suspect Canadian policymakers were using in 1980, financed much of this drilling. When prices began to soften, some pipelines decided that deep gas really wasn't twice as valuable as oil. In the subsequent shakeout, a lot of drillers took a very bad drubbing, at least one bank in Oklahoma went out of business, and several large U.S. banks have taken huge loan write-downs.

High-cost, subsidized oil and gas can never fare well in the competitive marketplace. A lot of synthetic fuels projects have been sent back to the laboratories and the pilot plants, and the blueprints for the Alaska gas pipeline are back on the shelf. What are the implications for Canada?

There are a lot of politics in the NEP, and the voters of Canada are going to have to make the final decisions on that. However, the world energy market has become much more competitive since the NEP was framed, and the surviving operators of the future are going to have to stress efficiency and low costs.

A national energy policy of taking revenues from the efficient, low-cost component of the industry via price controls and taxes, and then spending these funds on frontier drilling ventures that have little prospect of paying off for many years – if ever – will not help to keep the Canadian petroleum industry healthy and efficient. When this distorted economic setting is combined with a lingering hostility towards foreign investment, foreign suppliers of capital are going to continue to view Canada as an inhospitable place to risk their money. Canada could well end up owning more than 50 per cent of its oil and gas industry by 1990, but it may be more by a process of foreign capital flight from an unstable investment climate than by a process of healthy, efficient growth of Canadian firms. Some may claim this as a victory for the NEP, but I don't think that a high-cost, subsidy-dependent domestic industry is exactly what the taxpayers and voters of Canada bargained for.

Rationales for the NEP: rents, multinationals, and other goblins

My comments on the NEP to this point have focused on results: the takeover boom (and bust), and the impact of NEP policies on the volume and distribution of exploration and drilling. In talking with Canadians – especially those from the consumer provinces, such as

Ontario – I find that while many acknowledge the problems precipitated by the NEP, there still is some vaguely sentimental support for the 'ideas' the NEP allegedly represents, especially the idea of Canadianization. Some of this support may just be thinly-disguised economic nationalism. In other instances, it may reflect that naive xenophobia that a particular subset of Canadians have long exhibited towards all things American. But at least some of the ideas offered in support of the Canadianization objectives have enough superficial appeal to require more than a *prima facie* dismissal on grounds of irrelevance or simple chauvinism. Despite this veneer of sophistication, these more elaborate arguments still cannot stand much careful scrutiny. Some of the more obvious candidates for second-round dismissal are:

- concerns about the impact of foreign ownership and control of oil companies on Canada's ability to manage its own economic affairs;
- the issue of foreign investors benefiting from so-called 'rents' accruing to owners of Canadian oil and gas production; and
- the need for policies favouring Canadian oil and gas firms to offset the allegedly superior economic power and technical competence of foreign multinational oil companies.

Foreign control of oil and gas resources

Concerns over foreign ownership and control of oil and gas production often miss a very critical point: the greatest assets of these firms – their oil and gas reserves – are securely under Canadian soil and inherently subject to the sovereign power of the Canadian government. Moreover, the Canadian federal and provincial governments exercise very strict control over almost all aspects of oil and gas industry operations. Most mineral rights are permanently held by the government, and leasing is carefully controlled. Via licensing, the government determines who may explore and what may be produced. All prices paid to producers of oil and gas are controlled by government. Through lease sales, royalties, and numerous taxes, government picks up the lion's share of oil and gas revenues. And the price and volume terms of all oil and gas exports are rigidly set by government.

All of this makes for a very different situation from that, for example, of a foreign firm whose primary economic asset is a firm-specific market advantage in proprietary technology that has no tangible roots in Canada and can easily be denied to Canadians.[8]

Canada has an excellent technological base in the petroleum industry, so foreign oil firms have practically nothing in the way of firm-specific economic advantages that they can exploit at a cost to Canada. Oil and gas development is a very capital-intensive activity, however, and Canada – with its small, well-educated, population – stands to gain handsomely by expanding, not restricting, the sources of capital available to it for petroleum development.

Rents and windfalls

The question of 'rents' or 'windfall gains' has been a continuing topic in the energy policy debate in both in United States and Canada. The idea is based on the notion that if oil prices go up suddenly, the owners of pre-existing oil wells may reap an unexpected windfall gain.

Windfalls, of course, arise in all kinds of places in a market economy where people are still allowed to own private property. Collectors who bought gold coins in the sixties enjoyed windfalls when gold prices shot up in the seventies, as did the owners of gold mines or gold mining stocks. The antique boom of the last two decades brought windfalls to a lot of farmers who hadn't cleaned out the loft in the barn for a long time. And I'm sure we've all heard the stories about the people who bought homes in Toronto twenty years ago.

Windfalls on oil have been singled out as especially 'unfair', and the notion is popularly advanced that they must be taxed away, or 'captured' by the government, rather than left in the hands of the private investors who originally risked their capital in the oil business. Possibly this is because gold bugs, untidy farmers, and Torontonians are deemed appropriately virtuous custodians of their gains, while people in the oil industry have unspeakable vices and must be protected from their frailties through a careful plucking of their windfalls by a benevolent government. (This idea leaves me with the uneasy feeling that I have been missing out on a lot of fun.)

A cynical observer might suspect that these outcries over windfalls and rents were little more than a convenient camouflage for increasing federal tax revenues. Economists point out that a true tax on pure economic rent is the most neutral form of tax, in that it does not affect the allocation of resources. In the oil and gas industry, however, we are not dealing with pure Ricardian rents but with relatively short-term, quasi-rents. Nevertheless, if raising tax monies is your game, you can raise a lot of revenue in the short run by taxing a commodity that exhibits low elasticities of demand and supply. If you can also attach blame for the tax to a goblin – say, a rich Middle Eastern sheik, or an oilman from Calgary – all the better. Oil is an easy target. But that action has serious implications for future oil production.

The problem, of course, is that you are not really taxing the Middle Eastern sheik at all, but protecting him from the Calgary oilman and his compatriots who are trying to compete with the sheik in producing oil. The ultimate burden of the tax falls on future consumers, who have to make do with less energy at higher prices.

The supply of oil and gas is not price inelastic in the long run, and neither Canada nor the United States can afford a smaller indigenous oil and gas producing industry competing with OPEC. Nevertheless, the United States has imposed an excise tax on crude oil euphemistically called the 'crude oil windfall profits tax' (WPT). Although rationalized by alleged windfalls on wells completed before 1973, the tax has also been applied to new production, where it will have maximum disincentive effect. Not to be outdone, Canada's tax, the Petroleum and Gas Revenue Tax (PGRT), has been applied to all oil and gas revenues, even those attributable to pre-1973 price levels, and made ineligible as a deduction for federal income tax purposes. While the United States adopted their WPT in conjunction with the decontrol of oil prices, Canada has chosen to keep its price controls, but tax the oil and gas producers anyway.

The crude oil excise tax in the United States is clearly working against industry efforts to replace depleting domestic oil reserves. Levy[9] has estimated that the U.S. will lose between 10 and 17 per cent of its potential domestic oil production between 1985 and 1990 due to the reduced level of activity attributable to the disincentive effects of the excise tax. This shortfall of domestic production has to be made up by greater imports of foreign oil, which pays no 'windfall' tax. This in turn places upward pressure on the world oil price. I don't have any studies comparable to Levy's at hand for Canada, but it doesn't take much imagination to visualize the Canadian situation – the data of Table 1 are suggestive of what is already happening to cash flows and investment incentives.

The windfall debate in Canada is complicated by the foreign presence in the oil industry, and some fear that the 'rents' may end up in foreign pockets instead of Canadian pockets. Absent outright confiscation of private property, it is hard to pick those foreign pockets and remain within the provisions of reciprocal tax treaties. Hence, some official crocodile tears are shed over the unfortunate lack of 'efficient rent collecting mechanisms', and then a destructively inefficient excise collective device is adopted as a substitute.

I would like to take this opportunity to offer my Canadian friends an efficient alternative to their counterproductive tax and price control scheme for 'rent' collecting, namely, the creation of positive economic externalities for themselves. Simply reestablish a fair and competitive climate for the reinvestment of foreign-owned resource rents in the Canadian oil and gas industry. The externalities will then flow North again and show up in Canadian pockets as higher incomes, more jobs, greater gas export revenues, lower oil import bills, a stronger dollar, and growing government revenues.

Can Canada compete with the multinational oil companies?

Another theme of NEP proponents is the idea that multinational oil companies have an entrenched economic and technical advantage relative to Canadian firms. This situation has been aggravated by past tax policies that favoured established firms over new entrants. This notion has been used to rationalize the adoption of the program of direct cash drilling grants that has been conditionally tied to Canadian ownership shares. There are at least four things wrong with this whole line of argument.

First of all, while under the tax-based incentive regime of the seventies (largely accomplished via deducting depletion allowances and accelerated expense writeoffs), the production share of Canadian firms was actually growing relative to that of the multinationals, and a lot of this was attributable to new ventures. (Incidentally, a very similar trend was occurring in the United States under a similar tax regime.) Thus, the alleged advantage of multinationals was contradicted by the evidence, even before the NEP was launched.

Secondly, the above result is not surprising when you consider the underlying tax status of most of the new venture capital entering the oil and gas exploration business. In almost all cases, these are high tax bracket funds supplied by investors who are every bit as capable of using the tax incentives as established investors. If you went behind the corporate veil and looked at the range of net marginal tax brackets attributable to the owners of oil and gas production companies, you would undoubtedly find that the owners of 'Little Oil' are typically in higher brackets than the owners of 'Big Oil'. While we may harbour some populist envy towards the wealth of such investors, it is foolish to regard a high tax bracket as an economic advantage in and of itself. Drilling all the wildcat wells we need to find new oil and gas in the Canada and the United States isn't really a game for widows, orphans, or salaried economists.

Thirdly, while we may not all agree on the general merits of economic incentives for domestic oil and gas production, I think most economists would agree that any incentives have to be targeted very carefully at the activity you intend to promote. It should not be easy to divert incentive benefits to extraneous or wasteful undertakings on the periphery. It is also desirable that they be self-financing. The pre-NEP tax-based incentives met these requirements very well: cash drilling grants do not.

If the goal is oil and gas production, the incentive should benefit *successful* oil and gas production ventures which produce income. By tying their benefits to profitable ventures, tax incentives tend to be more than self-financing – they often produce net increases in tax revenues. Finally, they have minimal impact on the proper allocation of overall exploration and production resources. Those producers who do the most efficient job will enjoy the greatest rewards and have the greatest opportunities to take advantage of incentives.

Cash drilling incentives are poorly targeted, as they reward those who drill wells, not those who successfully produce oil and gas. From what I have read recently in the industry press about the results of the PIP, this is an important distinction. Drilling grants are poorly correlated with more income and tax revenue. Thus, they result in a substantial net drain on government coffers. And as has often occurred in military procurement programs, cost reimbursement schemes are rarely conducive to efficient performance. Instead, they tend to subsidize waste.

Finally, the notion that multinational oil companies have a systematic technological advantage relative to Canadians and Canadian oil companies is a myth and an undeserved slight to

Canada. Canadian oil companies have repeatedly proven their technological sophistication, both here in Canada and in foreign operations. Many of them have active, profitable operations in the United States, and Canadian oil firms have competed successfully in Latin America, the North Sea, Africa, and Asia. I doubt that anyone can challenge Canadian know-how in Arctic operations. Throughout the world petroleum industry, there is a surprisingly large contingent of Canadians in high-level managerial and technical positions. It may be part of the curious Canadian psyche to suffer from a mild inferiority complex in some dealings with the United States, but there is absolutely no need to apologize to anyone for the Canadian oil industry.

A CONCLUDING NOTE

Most of my remarks criticizing the NEP aren't new or novel, of course. And I would like to reassure the Canadians here that I am not antiCanadian. Can the NEP itself make that claim? It has imposed high costs on the Canadian oil industry, placed downward pressure on the dollar, drained federal and provincial government treasuries, almost tripled the unemployment rate in Alberta, and jeopardized the financial integrity of some very capable Canadian oil companies. Meanwhile, Canadians pay more than ever for energy and energy taxes, face continued energy supply insecurity, and have yet to reap any tangible gains from Canadianization. I will leave it to my Canadian friends to perform their own cost-benefit calculations on all of this.

It is probably of little comfort to note that variations on most of the ideas implemented in the NEP have also been tried out in the United States with similar costly, inefficient results: for example, price controls on oil and gas, excise taxes on domestic producers, restrictions on mineral lease ownership, distorted subsidy programs, policy 'tilts' against major companies, and so on. In 1981, we decontrolled crude oil prices and eliminated the ill-conceived program of 'entitlement' subsidies to selected refiners. The result was a prompt and sustained decline in consumer prices of petroleum products, plus a vigorous surge in exploration and drilling that was financed by private risk capital, not subsidies from taxpayers. Nonetheless, some problems remain south of the border. We still are burdened with the crude oil 'windfall' excise tax and we are still wrestling with natural gas price controls.

From my perspective on the American scene, I would like to add a sobering note of caution to those Canadians who disagree with the NEP, but who feel that the whole matter will simply and quickly take care of itself once they change the names on some office doors in Ottawa via the electoral process. In the United States, the whole system of oil price and allocation controls was set in place by Republican administrations who professed strong free market beliefs. In the current Congress, some members of President Reagan's own party are now pressing for new taxes on oil and gas and a strengthening of natural gas price controls. So we must keep in mind that no political party has a monopoly on bad (or good) economic policies.

If good economic policies are to prevail in the battle of ideas in either of our nations, they must be clearly articulated and vigorously pressed whenever the opportunity arises. Over these two days, I have been delighted to see that the public debate on Canadian and American economic policies continued to be lively and constructive here in Canada, which is as it should be. I am happy to have had the pleasure of participating in it with all of you at this workshop.

NOTES

1 The views and opinions expressed in this paper are solely those of the author, and should in no way be construed or represented as the views of Standard Oil Company (Indiana), its directors and management, or of any of its subsidiary companies.
In this final paper, the author's remarks given at the workshop have been expanded to respond to the views expressed by the other panelists as well as some of the issues raised in the subsequent discussion.

2 As quoted in Peter Foster 'Comment' *The Financial Post*, 5 November 1983.

3 *Platts Oilgram News*, 61(179) (15 September 1983), 1.

4 'Trudeau chooses worst parts of worst energy policies', *Oil and Gas Journal* 78(45) 10 November 1980, 137.

5 U.S. Congress, House Committee on Energy and Commerce, Subcommittee on Oversight and Investigations. Hearings on 'Impact of Canadian Investment and Energy Policies on U.S. Commerce', 19 June, 9 July, and 6 August 1981. Serial 97-41.

Also, see *Report*, together with *Dissenting Views* on 'Impact of Canadian Energy and Investment Policies on U.S. Commerce,' Committee Print 97-LL, October, 1982.

6 See Mack Ott (1981) 'How many bureaucrats does it take to drill an oil well', (University Park, Pa. 16802: Department of Economics, The Pennsylvania State University) Working Paper no. 1-81-1.

7 See Theodore R. Eck (1982) 'Future U.S. exploration – the key is economics'. *Oil and Gas Journal*, 16 August, 116.

8 I am indebted to Professor Alan Rugman of Dalhousie University whose presentation at this workshop introduced me to some very useful ideas on firm-specific versus country-specific economic advantages and their implications for foreign investment.

9 Yvonne Levy (1981) 'Crude oil price controls and the windfall profits tax' *Economic Review*, Federal Reserve Bank of San Francisco (Spring) 1-28.

Canada/U.S. automotive trade and trade-policy issues

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As automotive trade is the single largest area of economic interaction between Canada and the United States, there is at any point in time a number of automotive trade issues on the bilateral policy agenda. The purpose of this paper is to review the current major policy issues in Canada/United States automotive trade. As a backdrop, Table 1 lists the major events which have affected bilateral automotive trade policy relations and summarizes the major findings of the numerous government studies undertaken on the Canada/U.S. domestic automotive sectors.[1] Since there has been an unjustifiable preoccupation by both countries with the current year bilateral automotive trade balance, these trade data are included in the table. As the governments of Canada and the United States are currently under great political pressure to further restrict offshore imports of automotive products, Table 2 shows the offshore automotive trade balances for both countries.

In 1983, two reports (Lavalle-White [1983] in Canada and U.S. Department of Commerce [1983] in the United States) were published on the current state and future prospects of their respective domestic automotive sectors.[2] Both studies were commissioned separately in response to the major reductions in domestic automotive production, employment, and profits caused by the second oil price increase and the resultant increase in offshore import penetration into the de-

The author wishes to thank his two discussants, Thomas Atkinson and Bernard Ostry, and his colleagues John Curtis, Roman Lepiesza, and Gerry Salembier for their comments and criticisms on earlier drafts.

TABLE 1
The evolution of automotive issues in North America

	Bilateral trade balance[a]		Market share of offshore imports[b]	
	Under APTA	Outside of APTA	Canada	U.S.
Key developments in or affecting Canada/U.S. automotive issues	(millions-Cdn)		(% of total sales)	
1961-5 – Royal Commission on the Automotive Industry (Bladen) recommends that content requirements for duty remission programs be based on sales in Canada; Canada introduces duty remission program for automatic transmissions; Canada expands duty remission program to vehicles and other automotive parts; Modine Manufacturing Company of Racine, Wisconsin files petition for countervailing duty against Canadian imports because of remission program; Canada and the U.S. enter into intensive negotiations; Canada and the U.S. sign Canada-United States Automotive Products Trade Agreement (APTA); Congress passes Automotive Products Trade Act but voices displeasure with Letters of Undertaking and with not being consulted during the negotiations.				
1966	(540.8)	(118.1)	9.8	7.4
1967 – Canada agrees to reduce tariff on automobiles from 17.5 % to 15% in Kennedy tariff Round negotiations; U.S. agrees to cut automobile tariff from 6.5% to 3.0%; both agree to tariff cuts on other automotive products.	(542.7)	(113.4)	10.9	8.7
1968 – Automatic bilateral review of APTA exposes major fundamental disagreements between Canada and the U.S. over interpretation of objectives of APTA and over retention of safeguard condition; U.S. seeks removal of Canadian safeguards and opposes Canada's request for additional undertakings from vehicle manufacturers; Canada opposes elimination of safeguard conditions and insists on new Letters of Undertaking, however vague. – U.S. Senate Finance Committee conducts special hearings on termination of APTA. – Congress secures public agreement from U.S. manufacturers to oppose further Letters of Undertaking by subsidiaries in Canada. – In response to increasing global integration and interdependence, both Canada and the U.S. undertake major reviews of their own foreign policies.	(401.7)	(143.4)	14.1	10.3

TABLE 1 (continued)

Key developments in or affecting Canada/U.S. automotive issues	Bilateral trade balance[a]		Market share of offshore imports[b]	
	Under APTA	Outside of APTA	Canada	U.S.
	(millions-Cdn)		(% of total sales)	
1969 – U.S. President's Report on APTA states 'continued existence of the transitional restrictions (Canadian safeguards) is an obstacle to full realization of the Agreement objectives, has some adverse impact on the U.S. trade position, and would influence investment decisions and the trade position in the long term'; the U.S. demands removal of safeguards; Canada argues that safeguards essential to maintain a 'fair and equitable share' of North American automotive production. – A Bill to Repeal the Automotive Products Act of 1965 is introduced, but not passed, in the Senate.	(87.7)	(195.4)	16.1	11.3
1970 – Nixon administration removes U.S. 'tacit approval' of Letters of Undertaking. – Nominal wage parity reached between Canadian and U.S. automotive workers. – U.S. Senate Finance Committee requests President to ensure Canada/U.S. free trade in automotive products by 1973. – Automobile imports from Japan start to enter Canada and the U.S. in significant numbers. – Canada switches to floating exchange rate and Canadian dollar moves towards parity with U.S. dollar.	267.5	(156.6)	22.3	14.9
1971 – Nixon administration, in reaction to U.S. balance of payments problems, takes the U.S. off gold standard, devalues U.S. dollar, establishes DISC program, and imposes surtax on imports (automotive products imported from Canada are exempted); Canada seeks, unsuccessfully, exemption from surtax and reduces corporate tax rate to offset DISC. – As part of U.S. reaction to balance of payments problem, U.S. demands concerning APTA escalate rapidly from removal of safeguards to elimination of all Canadian restrictions on duty-free importation of automotive products and U.S. links automotive trade with defence trade and other trade issues; Canada refuses to acknowledge linkages and expresses concerns about lack of domestic automotive managerial and R&D activity and growing automotive parts trade deficit;	262.7	(146.1)	24.1	15.0

TABLE 1 (continued)

Key developments in or affecting Canada/U.S. automotive issues	Bilateral trade balance[a]		Market share of offshore imports[b]	
	Under APTA	Outside of APTA	Canada	U.S.
	(millions-Cdn)		(% of total sales)	
– Secretary of U.S. Treasury Connally recommends termination of the APTA but recommendation is not followed through. – In late 1971, U.S. informs Canada that surtax will be removed shortly but linkage between automotive and other trade issues is not dropped; Canada continues to resist linkage approach but indicates willingness to discuss modifications in safeguards.				
1972 – Canada and the U.S. hold informal meetings but no modifications in APTA are agreed to; U.S. continues to demand removal of safeguard conditions and Canada continues to demand their retention. – President Nixon addresses House of Commons: 'It is time for Canadians and Americans to move beyond the sentimental rhetoric of the past. It is time for us to recognize that we have very separate identities; that we have significant differences; and that nobody's interests are furthered when these realities are obscured'. – Prompted by U.S. economic measures in 1971, Canada announces Third Option. – U.S. Congress, which has begun to assert itself more strongly in U.S. foreign policy because of internal changes in the U.S. legislative system and growing dissatisfaction with executive secrecy and the Vietnam War, passes *Case Act of 1972* which requires text of all new international agreements to be submitted to Congress for review.	125.9	(206.7)	23.9	14.6
1973 – Price of oil triples because of OPEC. – House of Commons passes legislation to establish FIRA; U.S. response is relatively mute.	(158.2)	(277.5)	19.4	15.2
1974 – U.S. enacts Trade Act of 1974 which signals switch from trade policy as an instrument of overall U.S. foreign policy to trade policy as an explicit advancement of U.S. economic self-interests. – Canada institutes energy oil price policy to insulate domestic economy from increase in world energy prices; U.S. introduces price controls on domestically produced energy.	(782.6)	(453.6)	15.5	15.7

TABLE 1 (continued)

Key developments in or affecting Canada/U.S. automotive issues	Bilateral trade balance[a]		Market share of offshore imports[b]	
	Under APTA	Outside of APTA	Canada	U.S.
	(millions-Cdn)		(% of total sales)	
– President Ford and Prime Minister Trudeau agree to parallel studies 'to examine the state of the automotive industry'.				
1975 – Canada introduces remission program for non-U.S. producers to earn remission of duty on imported vehicles for parts exported from Canada except when exported to the U.S. – U.S. Senate Finance Committee requests U.S. International Trade Commission (U.S. ITC) to review whether Canada has complied with terms of APTA and has phased out safeguards. – Shifts of automotive investment, particularly in parts industry, to U.S. sunbelt (and, to a lesser degree, offshore) raises concerns; both Canada (federal and Ontario) and northern U.S. states start to counter with location incentives. – UAW (U.S.) and House of Representatives (Committee on Education and Labor) petition for antidumping duties on automobile imports from Canada, Europe, and Japan; U.S. ITC rules 'it did not determine there is no indication that the industry in the United States is being or is likely to be injured'; petition moves to U.S. Treasury. – U.S. enacts The Energy Policy and Conservation Act which stipulates that weighted average gas mileage for cars sold in the U.S. must reach 18 mpg by 1978 and 27.5 mpg by 1985; Act includes amendment that stipulates captive automobile imports must meet minimum 75% U.S. content, starting in 1979, in order to be eligible for inclusion in calculation of fleet mileage average.	(1404.9)	(547.0)	15.5	18.2

TABLE 1 (continued)

Key developments in or affecting Canada/U.S. automotive issues	Bilateral trade balance[a]		Market share of offshore imports[b]	
	Under APTA	Outside of APTA	Canada	U.S.
	(millions-Cdn)		(% of total sales)	
1976 – During ministerial discussions on various bilateral issues, Canada and the U.S. agree to examine ways to deal with Canada's growing parts deficit problem without renegotiating APTA and to study emerging problem of offshore sourcing of both captive and noncaptive parts. – U.S. ITC concludes that Canada has not fully complied with terms of APTA and only the U.S. made concessions under the agreement. – U.S. Treasury secures commitments from U.S. vehicle manufacturers to eliminate price differentials on vehicles between Canada and the U.S. and drops dumping investigation on imports from Canada. – Canadian dollar falls from above parity to approximately 92¢ U.S.	(460.3)	(468.8)	16.2	14.8
1977 – *Review of the North American Automotive Industry* (Arthur) warns that Canadian industry is vulnerable to structural changes in automotive industry and imports from offshore producers. – Canadian federal government under growing political pressure to renegotiate APTA to address problems of low Canadian-based R&D and management activity, growing parts trade deficit, low investment in parts sector, and high level of unskilled jobs; in response, federal government includes automotive industry in sector task force studies and presses, with limited success, major vehicle manufacturers and multinational parts producers for additional investment in parts production. – Canadian factory list prices of automobiles fall below U.S. factory list (exchange rate adjusted) prices for first time as Canadian dollar continues to depreciate. – Impact of Environmental, *Energy and Safety Regulations and of Emerging Market Factors in the U.S. Sector of the North American Automotive Industry* (U.S. Dept. of Commerce) concludes U.S. automobile companies have financial and technical capacity to meet U.S. mandates for safety emission, fuel efficiency and changes in the U.S. market; study does not discuss Canada/U.S. automotive trade, production, and investment issues.	(633.2)	(563.3)	19.5	18.5

TABLE 1 (continued)

	Bilateral trade balance[a]		Market share of offshore imports[b]	
Key developments in or affecting Canada/U.S. automotive issues	Under APTA	Outside of APTA	Canada	U.S.
	(millions-Cdn)		(% of total sales)	
1978 – Pennsylvania successfully outbids Ohio and provides $115 million incentive package to Volkswagen to establish new assembly plant. – Canada and Ontario win subsidy bidding war against Ohio with incentive of $68 million to Ford to locate new engine plant in Windsor. – *Report of Canadian Automotive Consultative Sector Task Force* (Bell) warns that pricing and cost constraints and tariff reductions may inhibit capital investment in Canadian automotive industry. – Canadian Senate Standing Committee on Foreign Affairs recommends that federal government pressure vehicle manufacturers to locate parts plant in Canada and APTA be fixed as a permanent treaty. – Senior Canadian and U.S. federal officials meet to discuss automotive trade issues; U.S. voices its opposition to federal and provincial incentives but indicates its own difficulties in controlling state incentives; differing views of APTA continue to plague bilateral discussions of automotive issues. – *Inquiry into the Automotive Industry* (Reisman) notes that annual service payments to U.S. parent companies from Canadian subsidiaries approaching $450 million, Canadian operations are more profitable than the U.S. operations, and recommends incentives for the parts industry and duty-free entry for non-APTA producers if they meet 60 to 75 per cent Canadian content in Canadian sales. – Canada enters into duty remission with Volkswagen which includes exports to the U.S.; U.S. voices opposition. – *Canada's Share of the North American Automobile Industry: An Ontario Perspective* (Ontario government) expands concept of 'fair share' to encompass employment, value-added, investment and R&D as well as production and trade.	(315.0)	(291.0)	17.5	17.6

TABLE 1 (continued)

Key developments in or affecting Canada/U.S. automotive issues	Bilateral trade balance[a]		Market share of offshore imports[b]	
	Under APTA	Outside of APTA	Canada	U.S.
	(millions-Cdn)		(% of total sales)	
1979 – Iranian revolution and second oil price jump; in months, North American producers go from excess demand for large cars to excess supply as the real price of gas jumps and gas lines form in U.S. – Canada announces R&D incentives for the parts industry and expresses desire to enter into bilateral negotiations outside the APTA to limit and control investment location incentives; the Canadian federal government states that it is neither its policy nor intention at this time to renegotiate APTA. – Canada agrees to cut tariffs on automobiles to 9.2% by 1988 in Tokyo Round tariff negotiations; U.S. agrees to cut tariff on automobiles to 2.5% by 1987; both countries also agree to tariff cuts in other automotive products.	(2650.0)	(434.0)	13.9	21.8
1980 – U.S. government provides loan guarantees of $1.5 billion (U.S.) to Chrysler; under domestic and U.S. pressure, Canada provides Chrysler Canada with $200 million (Cdn.) in loan guarantees; UAW in the U.S. and Canada make substantial wage concessions to Chrysler. – UAW (U.S.), followed by Ford, petitions for import relief from imports of automobiles; question of whether imports from Canada should be included is raised; U.S. ITC rules that imports are not the substantial cause of injury that other factors such as shift towards smaller cars and decline in overall demand are more important causes of injury. – Following 1980 election promises, Canada requests formal consultations under Article IV of APTA; Canada expresses concern about parts trade deficit and desire to increase investment in parts production and R&D in Canada; U.S. responds that 'any modifications (unilaterally implemented by Canada) would be considered a change in the terms of the APTA and would require the expressed approval of both the Executive and the Congress'.	(1812.6)	(346.6)	20.5	26.7

TABLE 1 (continued)

Key developments in or affecting Canada/U.S. automotive issues	Bilateral trade balance[a]		Market share of offshore imports[b]	
	Under APTA	Outside of APTA	Canada	U.S.
	(millions-Cdn)		(% of total sales)	
– Canada introduces the National Energy Program in 1980 budget and proposes changes to FIRA; U.S. voices strong opposition to both and bilateral relations start to rapidly deteriorate. – U.S. enters negotiations with third countries, including Japan, to induce offshore automotive producers to establish facilities in the U.S. – Three European companies and one Japanese firm agree to participate in an expanded Canadian duty remission program. – Canada enters discussions with Japan to solicit Japanese automotive investment in Canada and to increase purchases of Canadian parts by Japanese automobile producers.				
1981 – The U.S. Automobile Industry, 1980 (U.S. Dept. of Transportation) concludes that major adjustments required in all areas of automotive sector; companies, labour and government must all take responsibility for solutions to current problems, future of industry linked directly to overall U.S. national interests and security, and recommends major policy package of Japanese export restraints, tax changes, regulatory changes, and labour adjustment programs; Canada is only briefly referred to. – The bilateral dispute over NEP and FIRA escalates with the switch from quiet diplomacy and problem-solving approach to public and high-profile political posturing; bilateral consultations on a wide range of issues become strained. – Congress introduces bill to legislate quotas on automobile imports from Japan; Reagan administration opposes the bill but negotiates a three-year export restraint arrangement with Japan. – Congress introduces a number of trade reciprocity bills; all are strongly opposed by Reagan administration. – Canada and Volkswagen conclude broadened duty remission plan based on 85 per cent Canadian content and Volkswagen agrees to establish parts plant in Ontario; U.S. expresses strong opposition.	(1496.6)	(535.4)	28.4	27.3

TABLE 1 (continued)

Key developments in or affecting Canada/U.S. automotive issues	Bilateral trade balance[a]		Market share of offshore imports[b]	
	Under APTA	Outside of APTA	Canada	U.S.
	(millions-Cdn)		(% of total sales)	
– President Reagan signs Economy Recovery Tax Act of 1981 to cut personal and business tax rates over three years; President Reagan also orders major review of 34 automobile-related regulations to find ways and means to reduce the cost burden on U.S. automobile producers, proposes changes to the Anti-Trust legislation to allow joint-ventures in automotive R&D, and proposes changes to existing labour adjustment assistance programs to provide greater coverage for automotive workers. – Canada negotiates one-year export restraint arrangement with Japan. – European countries introduce or expand restrictions against Japanese automotive parts.				
1982 – The U.S. Automobile Industry 1981 (U.S. Dept. of Transportation) shifts emphasis of policy recommendations to allowing market forces to determine adjustment; again Canada only mentioned in passing. – With amendment that Act not supersede APTA, House of Representatives passes 'Fair Practices in Automotive Products Act' which would legislate domestic content in automobiles sold in the U.S.; strong opposition to bill from Reagan administration and the senate; bill dies on senate order table. – Canada changes approach in dealing with U.S. by increasing direct contact of Canadian embassy with Congress and increasing budget for consultants and lobbying on Capitol Hill. – Congress and Reagan administration agree to jointly draft a reciprocity bill; proposed legislation, *Reciprocal Trade and Investment Act of 1982* introduced in Senate. – U.S. makes major changes in 29 safety and emission regulations to reduce cost of compliance to U.S. producers, and changes and introduces labour adjustment programs and other policies to assist adjustment in automotive sector.	2554.5	156.6	31.4	27.9

TABLE 1 (continued)

	Bilateral trade balance[a]		Market share of offshore imports[b]	
Key developments in or affecting Canada/U.S. automotive issues	Under APTA	Outside of APTA	Canada	U.S.
	(millions-Cdn)		(% of total sales)	
– After prolonged and difficult negotiations in which Canada raises issues of Japanese trade barriers on various products and Japanese purchases of Canadian automotive parts, followed by Canadian slowdown of customs processing of automobile imports from Japan, Canada and Japan reach agreement on automobile export restraint for second year. – Honda begins production in Marysville, Ohio. – UAW (U.S.) provides major wage and nonwage concessions to GM and Ford; UAW (Canada) initially opposes providing similar concessions but reaches agreements with GM and Ford involving mostly concessions on nonwage benefits.				
1983 – *The U.S. Automobile Industry, 1982* (U.S. Dept. of Commerce) states that U.S. automotive industry has made remarkable progress in adjusting and role of government is to ensure smooth and orderly adjustment and not to provide protection against economic changes in automotive industry and market; Canada only mentioned once with regards to labour conditions. – *An Automotive Strategy for Canada* (Lavalle and White) recommends that all vehicle manufacturers selling to Canada be required to meet Canadian production and content commitments comparable to those under the APTA and, over time, to increase level of minimum content commitments; recommendations are endorsed and supported by vehicle producers, UAW and independent parts producers in Canada. – House of Representatives passes the Fair Practices in Automotive Products Act but questions of imports from Canada unresolved; Reagan administration continues to oppose bill. – While general state of the bilateral relationship improves generally, numerous bilateral problems and disputes arise because of differences in basic policy approaches, and deregulation in the U.S., particularly in the service sector.	1400.0[b]		25.2*b*	27.1

TABLE 1 (continued)

Key developments in or affecting Canada/U.S. automotive issues	Bilateral trade balance[a]		Market share of offshore imports[b]	
	Under APTA	Outside of APTA	Canada	U.S.
	(millions-Cdn)		(% of total sales)	
– A *Review of Canadian Trade Policy and Canadian Trade Policy for the 1980s* (Canada, Dept. of External Affairs) recommend greater attention to Canada/U.S. trade and exploration of negotiating sectoral free trade agreements with the U.S.; U.S. response to two studies is favourable and both countries enter exploratory discussions on options and sectors. – Sales, production, employment, and profits of U.S. owned automotive firms in Canada and the U.S. show major improvements as consumer preference shifts back towards intermediate and larger cars. – U.S. negotiations with Japan limit Japanese automobile exports for a fourth year (1984). – Canada and Japan reach agreement on Japanese automobile exports for a third year. – Nissan begins production of light trucks in Smyrna, Tennessee. – G.M. and Toyota announce joint venture to produce subcompacts in Fremont, California; Ford and Chrysler oppose joint venture. – Toyota announces intention to establish aluminum wheel rim plant in British Columbia; governments of Canada and BC provide 5.5 million of 23 million investment in low interest rate loans.				

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[a] Expressed as net Canadian exports (brackets indicate Canadian automotive trade deficit). Data from White and Lavelle (1983); trade data are not reconciled with U.S. trade data. Trade under the APTA only includes trade by bona fide manufacturers under the APTA. Trade outside of the APTA consists of trade in certain specialized vehicles not included under the APTA and all aftermarket parts trade.

[b] First six months of 1983 data by Under APTA and Outside of APTA not available.

SOURCES: See References, particularly Dykes (1982), Kirton (1980/81), Reisman (1978), Perry (1982), and U.S. President's Report on The Automotive Products Trade Agreement (various years).

TABLE 2
North American – Offshore automotive trade balance[a]

	Canada (Millions-Cdn.)						United States (Millions-U.S.)		
	Parts		Vehicles		Total				
	Under APTA	Outside APTA	Under APTA	Outside APTA	Under APTA	Outside APTA	Parts	Vehicles	Total
1972	(1)	(82)	58	(422)	57	(503)	(119)	(2832)	(2951)
1973	23	(97)	58	(334)	80	(431)	(355)	(3202)	(3557)
1974	12	(110)	126	(378)	138	(489)	(348)	(3597)	(3945)
1975	32	(110)	316	(198)	339	(308)	464	(2392)	(1928)
1976	+2[b]	(112)	310	(431)	311	(543)	(305)	(3458)	3763
1977	17	(148)	474	(495)	491	(644)	(929)	(4889)	(5818)
1978	126	(202)	531	(714)	658	(916)	(2507)	(6962)	(9469)
1979	172	(239)	460	(624)	632	(862)	(2516)	(7882)	(10398)
1980	522[c]	(358)[c]	205	(1014)	727	(1220)	(2144)	(10227)	(12371)
1981	275[d]	306[d]	392	(1352)	650	(1046)	516	(12173)	(11657)
1982	595	(194)	95	(1044)	690	(1238)	(328)	(13424)	(13762)

NOTES:

a Expressed as net exports; brackets indicate deficit; excludes all bilateral trade.
b Surplus of less than $0.5 million.
c Classification problem with export of CKD parts and vehicles.
d Includes CKD parts.

SOURCE: Lavalle-White (1983) and U.S. International Trade Commission (1983).

pressed home markets.[3] While noting that recession had exacerbated the situation, both studies concluded that the economic problems confronting automotive producers and workers were structural problems which would not be solved by cyclical recovery. They both went on to discuss the difficult and expensive tasks of restructuring the domestic automotive sector to improve productivity and competitiveness, and each report focused on the critical role of technology in the adjustment process and for the future competitiveness of each domestic automotive company. As offshore imports, particularly from Japan, were the 'visible' cause of the disruptions in the domestic automotive sectors, the reports identified the major reasons for both the competitive advantages of the Japanese automotive producers and the offshore sourcing of key automotive components by the major U.S. vehicle companies. Each study, moreover, defined the public policy question in terms of critical national interest, documenting the strategic importance of the automotive sector as an employer, a creator and user of high technology, and a major purchaser as well as producer of manufactured goods.

The two reports departed on the policy recommendations. Lavalle-White (1983) identified the major policy issue as protecting jobs and the main problems for adjustment as the truncation of the domestic automotive sector and the lack of Canada's 'fair share' of automotive production and investment. The study highlighted the ongoing structural problems of low research and development in the Canadian automotive sector, the concentration on low-skilled, labour-intensive production and the lagging competitiveness of the Canadian parts industry, particularly the small independent parts producers. It stressed strongly that policies be based on equity in terms of the commitments by each vehicle company to Canada and directed to obtaining a 'fair and equitable share' of automotive activity in Canada commensurate with the benefits of selling in Canada. The report argued that the existing restraints on Japanese automobile imports provided insufficient protection and proposed that the current commitments under the Canada-United States Automotive Products Trade Agreement (APTA) be extended to all automobile companies selling in Canada and that, after a period of transition, these commitments be raised. Other recommendations included incentives for research and development and capital investment for the parts industry and labour-adjustment policies to deal with the problems of high unemployment and labour retraining. The recommended policy package was not a major departure from the traditions of Canadian automotive policymaking. Canadian automotive policy has always been directed to offsetting the problems of a small domestic market and the domination of the domestic automotive sector by foreign-owned multinational companies. As noted in Lavalle-White (1983):

> At each stage in the evolution of the Canadian automotive sector, any threat to Canada's fair share of automotive manufacturing relative to domestic consumption has been countered by domestic policies – whether tariffs, content schemes or manufacturing requirements – that have sought automotive investment, production and employment in Canada. (Lavalle-White 1983, p. xi)

U.S. Department of Commerce (1983), on the other hand, defined the basic policy issue as economic adjustment to changes in market conditions. The underlying policy assumption in the study was that the U.S. automotive sector had the financial, management, and technological capabilities to adjust to the increased offshore competition in the U.S. market and, at the same time, to meet the legislative requirements for safety, emissions, and fuel efficiency. The main impediments to structural adjustment were determined to be the short-run financial burdens placed on each company by depressed sales, high interest rates and major investment requirements, and foreign policies which have exacerbated the excess automotive production capacity problem in the global automotive market. The report documented the protectionist policies implemented by the U.S. federal government after 1979 but it stressed that abnormal and disruptive conditions were the reason for the sharp departure from the traditional U.S. automotive policy approach of nonintervention. It concluded that medium-term viability of the domestic industry was assured and opposed further trade protection for the U.S. automotive sector with the warning that policymakers have 'an obligation to face the realities of the market place' (U.S. Department of Commerce 1983, p. 1). While the report identified numerous changes in safety and emission regulations to reduce the financial costs of compliance and in labour-community adjustment programs to ease the social costs of adjustment, the main policy emphasis was on allowing the market to work, aided by general economic incentives through macroeconomic policy. By stressing freer markets and liberalized trade, the study called for a return to traditional U.S. automotive policy and implicitly but directly challenged a proposal in front of the U.S. Congress to legislate U.S. domestic content regulations.

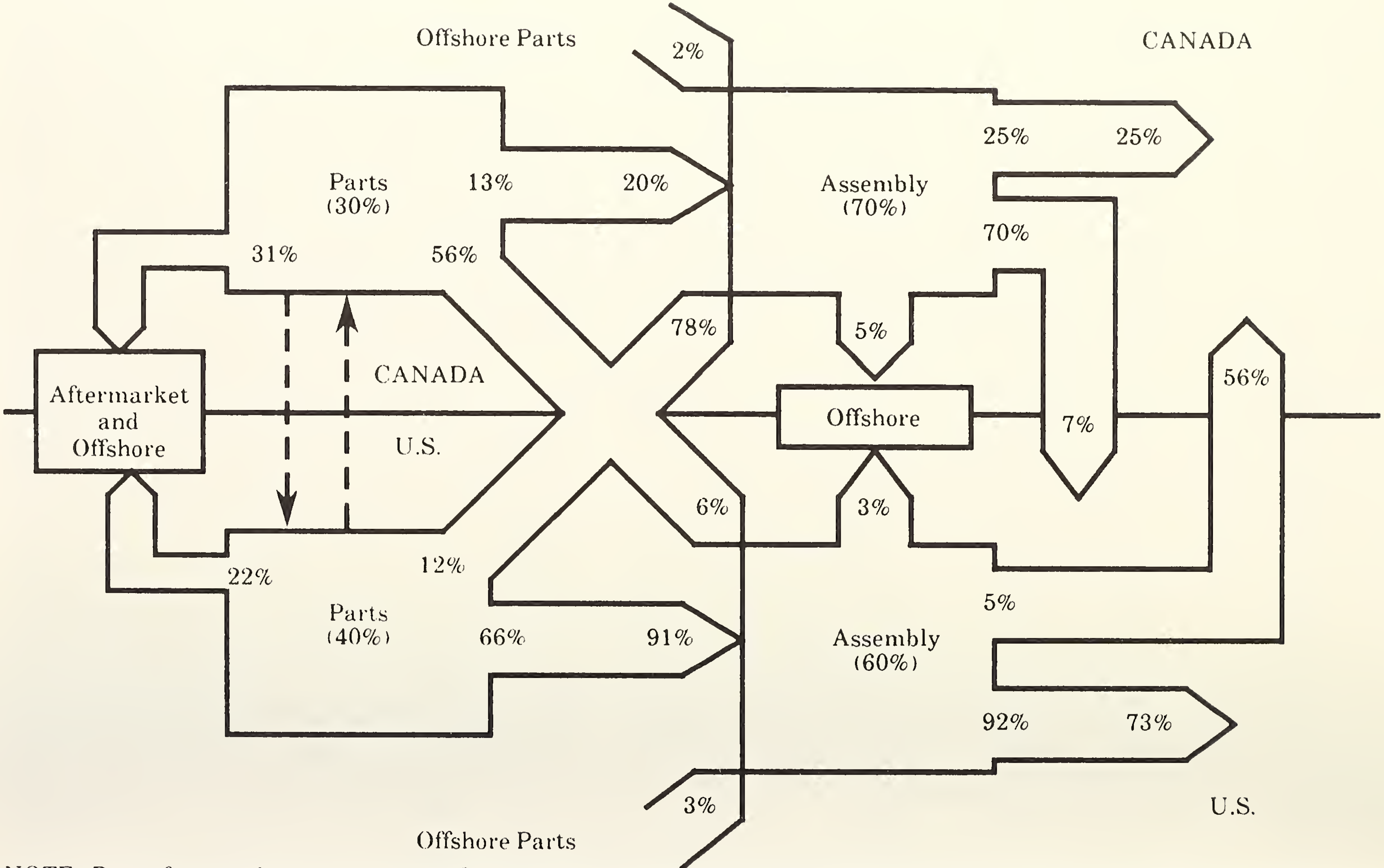
DOMESTIC STRUCTURE AND THE APTA

The sharp contrast in the policy recommendations of the Canadian and U.S. reports reflects the basic differences in the economic structures of the automotive sector in each country and the asymmetric pattern of bilateral production, trade, and investment. The U.S. automotive sector is domestically owned and controlled and consists of large independent parts producers and the large vehicle assembly companies. Dominated by the Big Three – GM, Ford, and Chrysler – it is a fully integrated sector, conducting the full range of management activities from corporate planning to financial and purchasing functions to research and development, and producing the entire range of components and vehicles. As shown in Figure 1, the Big Three source most of their original equipment parts from within the United States and sell most of their output in the U.S. domestic market. Less than 10 per cent of total U.S. vehicle production is exported and only about 15 per cent of total U.S. parts production is exported, and in both cases, Canada is by far the largest export market.

The Canadian automotive sector, on the other hand, is mostly foreign-owned and controlled. Both the parts and assembly industries are dominated by the U.S. Big Three who provide much of the major managerial functions and services for their Canadian operations from their head offices in the United States. Assembly is concentrated in the production of larger vehicles and as shown in Figure 1, over 70 per cent of Canadian-produced vehicles are exported to the United States. The Canadian assembly is heavily dependent on imports of original equipment parts and approximately 45 per cent of the parts used in Canadian assembly come directly from the parts plants of the major U.S. vehicle companies in the United States.

The Canadian parts industry includes, in addition to in-house operations of the Big Three, a few large, mostly foreign owned, independent parts producers and a large number of small, diverse, Canadian and foreign-owned, independent parts producers. While over 40 per cent of the parts produced in Canada by the Big Three are

FIGURE 1
Structure of North American automotive sector, 1976-1981


Offshore Parts
2%
CANADA
Parts
(30%)
13%
20%
Assembly
(70%)
25%
25%
31%
56%
70%
78%
5%
CANADA
U.S.
Aftermarket
and
Offshore
Offshore
7%
56%
6%
3%
12%
22%
5%
Parts
(40%)
66%
91%
Assembly
(60%)
92%
73%
3%
U.S.
Offshore Parts

NOTE: Base of arrow shows percentage of output sold to purchaser; tip of arrow shows percentage purchased from source; brackets show percentage of total national automotive production; all percentages plus or minus 2.5; offshore vehicles not included.

exported to the United States, the demand for these parts, particularly the engines and transmission, are dependent on the North American demand for larger automobiles, vans, and light trucks. The large independent parts producers produce a wide range of standard and sophisticated products and over 75 per cent of the value of their production is sold in the Canadian market. In contrast, the small independent parts producers rely heavily on exports to the assembly plants of the Big Three in the United States, for which they are primarily marginal suppliers of low technology, labour-intenstive parts.

Since 1965, bilateral automotive trade has been conducted under the conditional duty-free conditions established by the APTA. This bilateral-trade agreement provided an institutional framework for the Big Three to integrate their Canadian operations into the large U.S. automotive sector to serve the entire North American market. It also provided access to the U.S. original equipment parts market and a growing Canadian original equipment parts market for the Canadian independent parts producers. This agreement has enabled product rationalization in Canadian vehicle and parts production to exploit the economic efficiencies of large scale production. As a result of the APTA, production efficiency in Canadian assembly operations now equals, if not surpasses, that in U.S. assembly operations. While it is difficult to generalize for the parts industry, this industry has also experienced major increases in productivity and competitiveness as a result of the APTA, and certain segments match the production efficiency of U.S. parts operations. In that the APTA was a limited purpose tool designed to solve the problem of low-volume production in Canada and increase Canada's share of North American automotive production, it has been a successful policy action from which Canada has reaped large benefits in automotive employment, production, investment, and trade, as well as real incomes throughout the economy.[4]

As shown in Table 3, bilateral automotive trade has expanded greatly under the APTA. The pattern of bilateral automotive trade was established immediately after 1965 and, as will be discussed below, this pattern has become a focal point in the bilateral disputes over the APTA.[5] In most years, the United States registers an overall surplus on both the APTA account and the non-APTA account.[6] The U.S. surplus on the APTA account is almost entirely due to positive

TABLE 3
Canada/U.S. trade in automotive products within and outside the Auto Pact[a]

	U.S. imports from Canada							Canadian imports from U.S.						
	Under APTA			Outside APTA				Under APTA			Outside APTA			
	Motor vehicles	Parts	Sub-total	Motor vehicles	Parts	Tires & tubes	Sub-total	Motor vehicles	Parts	Sub-total	Motor vehicles	Parts	Tires & tubes	Sub-total
1966	481.4	338.8	820.2	4.4	49.2	8.6	62.2	371.3	989.7	1361.0	38.5	132.1	9.7	180.3
1967	988.0	458.2	1446.2	4.4	53.2	12.9	70.5	772.9	1216.0	1988.8	36.3	140.0	7.6	183.9
1968	1588.0	789.4	2377.4	9.9	54.3	8.6	72.8	1073.4	1705.7	2779.1	37.7	149.4	29.1	216.2
1969	2247.7	953.6	3201.3	10.3	70.9	5.4	94.6	1120.8	2168.2	3289.0	56.6	196.6	36.8	290.0
1970	2115.4	1037.8	3153.2	12.3	89.4	14.6	116.3	880.3	2005.4	2885.7	65.6	183.3	24.0	272.9
1971	2473.6	1386.2	3859.8	62.1	109.3	8.1	179.5	1283.6	2313.5	3597.1	76.6	213.6	36.4	325.6
1972	2738.1	1645.0	4383.1	13.5	133.3	21.8	168.6	1538.7	2718.5	4257.2	87.2	237.6	50.5	375.3
1973	3040.2	2048.0	5088.2	20.8	123.6	68.0	212.4	2010.1	3236.3	5246.5	94.1	303.8	92.0	489.9
1974	3391.0	1816.9	5207.9	14.3	136.1	63.6	214.0	2443.9	3546.6	6990.5	108.1	341.4	218.1	667.6
1975	3726.1	1909.2	5635.3	60.5	131.4	68.1	260.0	3000.3	4039.9	7040.2	277.6	356.6	172.8	807.0
1976	4703.6	2766.6	7470.2	69.1	174.9	163.7	407.7	3129.7	4800.8	7930.5	201.3	578.8	114.4	894.5
1977	5942.8	3488.4	9431.2	51.4	112.7	143.6	307.7	3846.1	6218.3	10064.4	206.2	511.7	153.1	871.0
1978	6972.0	4421.0	1393.0	61.0	325.0	191.0	577.0	4283.0	7425.0	11708.0	77.0	661.0	130.0	868.0
1979	6622.0	4072.0	10694.0	84.0	417.0	234.0	735.0	5564.0	7780.0	13344.0	135.0	879.0	155.0	1169.0
1980	6612.2	3008.1	9620.3	56.3	374.0	229.9	660.2	4542.6	6890.3	11432.9	148.6	712.6	145.6	1006.8
1981	8141.7	3670.7	11812.4	118.7	398.4	239.0	756.1	4944.8	8364.2	13309.0	236.2	908.6	136.7	1281.5
1982	11023.1	4292.4	15315.5	93.2	602.3	405.4	1100.9	3705.2	9055.8	12761.0	101.6	722.2	120.5	944.3

NOTES:

a Data not reconciled with U.S. automotive trade statistics. For balances, see Table 1.

b Includes CKD imports.

SOURCE: Lavalle-White (1983)

net exports to Canada of original equipment parts produced by the Big Three themselves. APTA trade in original equipment parts produced by the independent parts producers has remained roughly in balance since the early 1970s and Canada has posted a considerable surplus in vehicle trade in every year since 1965.[7]

The production structure of the Canadian automotive sector and pattern of North American automotive trade are the direct products of the Canadian safeguard conditions in the APTA and the commitments in the Letters of Undertaking which accompanied the APTA.[8] To reach its stated objective of a 'fair and equitable share' of North American automotive production, Canada insisted on the following safeguards in the APTA:[9]

- Only companies producing in Canada and designated as 'bona fide' manufacturers of vehicles can import vehicles and original equipment parts duty-free; there are no restrictions on the origin of these vehicles and parts.
- In each model year, the company is required to maintain a minimum ratio of Canadian production to Canadian sales in each class of vehicle – cars, commercial vehicles, buses – of 75 per cent or the percentage obtained in the 1964 model year, whichever is higher.[10]
- The amount of Canadian value added be no less in any given model year than that obtained in the 1964 model year.
- After market parts are not included in the APTA.

The Canadian federal government also sought and obtained Letters of Undertaking from the Big Three. These Letters of Undertaking were outside the formal agreement signed by the two governments and, since 1968, they have had no legal basis for enforcement. With the exception of one year, 1980, the U.S. assembly companies have collectively continued to meet the commitments which require:

- The amount of Canadian value added in vehicles to increase by 60 per cent of the increase in the cost of sales of vehicles sold in Canada and 50 per cent of the increase for commercial vehicles sold in Canada.
- The producers collectively increase Canadian value added by $260 million by the end of the 1968 model year.

Canada has benefited enormously from these safeguards and commitments. However, under the APTA, the Canadian automotive sector is an appendage to the U.S. sector and vulnerable to U.S. automotive policies. At the same time, as the APTA sets both the structure and performance of the Canadian industry, it is drawn into virtually every automotive policy issue that arises in Canada. From here it is but a short jump to the bilateral agenda. What the APTA does is to ensure that the economic problems of the Canadian automotive sector are translated into continuing political and, especially, diplomatic problems for the Canadian government (Winham 1983, p. 11). It also dictates that the Canadian federal government be seen as managing the problems in the Canadian automotive sector and the bilateral automotive trade policy relationship. And the ability of the Canadian federal government to manage both the domestic and bilateral problems has become increasingly more difficult because of the erosion of the effectiveness of the Canadian safeguards and commitments and the U.S. opposition to their continuation.

As a result of inflation and sector growth, the third safeguard and the last commitment – the two requirements which establish the absolute base for Canadian value added – are now largely redundant. While the ratio requirement is still legally binding, it does not provide Canada with protection against market downturns or against changes in consumer preferences. Moreover, the effectiveness of ratio safeguard and the growth commitment are now in jeopardy. Since both conditions are tied to Canadian sales, the ratio safeguard and the growth commitment have become less effective in protecting Canadian automotive production and employment as the market share of offshore imports has increased.

The most important safeguard, however, is the first condition of the APTA which designates the conditions for duty-free access to Canada. As participation in the APTA by the U.S. vehicle companies is voluntary, the first condition provides both the incentive for the companies to participate and the only means by which Canada can ensure their compliance to the other conditions. In 1965, the APTA provided an implicit subsidy to the U.S. vehicle companies by allowing them to charge prices to Canadian consumers significantly above their production costs and, at the same time, allowing them to take advantage of the lower Canadian dollar, the lower Canadian automotive wages, the cost reductions from product rationalization and the protection provided by the Canadian automotive tariffs against offshore imports.[11]

The implicit subsidy has now been largely eliminated. Nominal wage parity between automotive workers in the two countries was reached in 1971, and Canadian tariffs for automotive products have been reduced significantly through multilateral trade negotiations. By 1987, the Canadian tariff rate on automobile imports will be 9.2 per cent. This nominal rate would appear to provide adequate scope for an implicit subsidy; however, the U.S. Congress in 1976 further constrained the margin between Canadian and U.S. prices by securing commitments from the U.S. vehicle companies to eliminate the factory price differentials between the two countries except where justified by higher production costs. The only remaining source of a subsidy today is the lower Canadian dollar which allows Canadian factory prices, when denominated in U.S. dollars, to be lower than U.S. factory prices for comparable vehicles. However, with the uncertainty of exchange rate markets, this 'dollar' subsidy is at best a minor factor in the production and investment decisions of the U.S. vehicle companies.

The erosion of the implicit subsidy plus the lack of an effective provision to ensure that the U.S. vehicle companies continue to operate under the APTA have underscored Canadian attempts to strengthen the Canadian conditions of the APTA.[12] This desire to strengthen the protection provided by the APTA to the Canadian automotive sector has been reinforced by the decline in the margins by which the U.S. vehicle companies have collectively exceeded the minimum production and content requirements stipulated under the APTA. As shown in Table 4, these margins narrowed considerably between 1972 and 1982. In 1980 Ford failed to meet the APTA conditions for each class and, in order to avoid a major disruption, the Canadian federal government negotiated an arrangement which allowed Ford to transfer production across classes of vehicles in exchange for new automotive investment.[13] While the U.S. vehicle companies have posted major improvements in their production and content performances since 1981, much of this gain is due to the switch by U.S. consumers back to larger vehicles which are produced in Canada.

The United States has not only opposed any suggestions that the Canadian conditions be strengthened to protect the Canadian auto

TABLE 4
Performance of U.S. vehicle companies under APTA

	Production-sales ratio[a]			CVA commitments (%)	
	Passenger vehicles	Commercial vehicles	Buses	Achieved[b]	Required[c]
1970	1.66	1.62	1.11	92	70
1971	1.49	1.42	1.20	95	69
1972	1.25	1.22	1.19	90	66
1973	1.21	1.15	0.97	79	64
1974	1.22	0.98	1.02	71	62
1975	1.22	1.01	1.14	66	61
1976	1.22	1.13	0.98	67	61
1977	1.25	1.32	1.05	72	60
1978	1.30	1.55	1.63	74	59
1979	1.30	1.27	1.83	64	58
1980	1.06	1.15	1.99	53	57
1981	1.23	1.40	2.73	62	58
1982	2.02	2.38	2.13	91	59

a For minimum required ratio for each class, see footnote 10.
b Realized Canadian Value Add (CVA) as percentage of cost of sales in Canada.
c Minimum required CVA as percentage of cost sales in Canada.
SOURCE: Lavalle-White (1983).

motive sector but has demanded the removal of the existing conditions. The U.S. administration accepted the Canadian safeguards and commitments on the belief that they would only be in place for a limited, transitional period to allow the Canadian automotive sector to adjust to the new framework under the APTA.[14] In 1968, Canada and the United States began feuding over the interpretation of the objectives of the APTA and the retention of the Canadian safeguards and commitments. By 1970, the APTA was caught up in the U.S. balance of payments problems and the Nixon Administration strongly demanded the elimination of the Canadian safeguard and commitment conditions under the APTA, and a full liberalization of bilateral automotive trade. These demands have been restated by each subsequent administration, and U.S. opposition to the Canadian conditions has hardened over time because of the international developments in the global automotive market, the increasing dependency of the United States on trade and the change in the relative position of the United States in global political-economic affairs. These factors have also reinforced the Congress's original dissatisfaction with the APTA and many congressmen view the APTA as a major mistake in U.S. trade policy.

Canada has vigorously defended the safeguards and content commitments, arguing that they are required to offset the 'institutional barriers' which distort the economics of producing and investing in Canada. The 'institutional barriers' cited include the desire of the U.S. companies to maintain major managerial activities and control in the United States and the asymmetric influence of U.S. political developments on the production and investment decisions of the U.S. companies. As evidence of such barriers, numerous Canadian studies have documented, amongst other things, the low level of earnings retained in Canada by the U.S. vehicle companies and, despite the higher profitability of Canadian operations relative to U.S. operations, the minimal investments by the Big Three. Canadian analysts, commentators, and governments have also pointed to the lagging competitiveness of the parts industry, the declining U.S. market share of the small Canadian independent parts producers and the chronic deficit on bilateral parts trade as evidence of the weakness of the Canadian conditions of the APTA and hence the need to strengthen them.

The United States has countered by arguing that the main objective of the APTA has always been to establish 'conditions in which market forces may operate effectively to attain the most economic patterns of investment, production and trade' (APTA, p. 1). The continuation of the Canadian safeguards and commitments are viewed as preventing the realization of this objective and adversely affecting the investment decisions of the U.S. automotive companies and hence the economic interests of the United States. U.S. government officials have rejected Canadian arguments about the chronic Canadian deficit on bilateral parts trade by asserting that the intention of the APTA was not, and is not, to balance bilateral automotive, either overall or by category. At the same time, these officials have pointed to the consistent Canadian surplus in vehicle trade as evidence of the benefits to Canada, and some U.S. commentators have argued that the Canadian surpluses in total bilateral automotive trade in 1982 and 1983 further demonstrate the unfair advantages provided to Canada by the APTA. The position of the Reagan administration on the APTA is that:

> The United States has rejected the 'fair share' concept on the grounds that the [APTA] is a limited free trade agreement, not a market sharing agreement or a mechanisms to manage an industrial strategy for the auto industry. (Office of the USTR 1981, 54)

While both countries would like to renegotiate the APTA, the objectives each would seek in such negotiations are diametrically opposed. The Canadian and U.S. federal governments have continued to publicly express their commitment to the APTA, primarily because of the fear of the disruption its termination would cause within the North American automotive sector. However, the North American automotive sector has been severely disrupted by outside forces. The international developments in the global automotive sector have directly affected the economic structure of the North American automotive market and hence the policy environment in which the bilateral automotive trade and trade policy relationships are conducted. While the structural problems and policy concerns for Canada have not changed fundamentally, they have been magnified and must now be dealt with in an increasingly competitive and uncertain bilateral and multilateral environment. In the case of the United States, both the problems and the environment have changed, confronting U.S. policymakers with a new set of automotive problems and policy issues.

INTERNATIONALIZATION, ADJUSTMENT, AND ISSUES FOR NORTH AMERICA

The negotiating of the APTA in 1965 was premised on the basic assumption that the North American automotive market was fundamentally different, and hence, separable, from outside automotive markets. As corollaries to this basic assumption, both the automotive companies and the governments in North America further assumed that domestic vehicle demand would grow steadily within a naturally protected, oligopolistic and stable North American market; that the required additional production capacity would be located in North America; and that the automotive sector would continue to be owned by North Americans and dominated by the Big Three. These assumptions have now been invalidated by the developments in the international automotive market.

The most important development has been the increase in the real price of oil since 1973. As indicated in Table 5, the resultant increase in the real price of gasoline has induced a shift in North American consumer preferences from large, luxury-oriented, fuel-inefficient vehicles to smaller, quality-oriented, fuel-efficient vehicles. The second oil price increase in 1979 effectively eliminated the natural protection provided by consumer preferences to the North American producers in their home market, and the convergence of North American consumer preferences towards those outside the continent has forced deep structural changes in the North American automotive sector.

The North American automotive companies have been required to undertake these structural adjustments in the face of slow market growth and excess capacity in world automotive production. Since the mid-1970s, the growth rate of global vehicle demand has declined significantly. The three major vehicle markets – North America, Europe, and Japan – have reached the point of saturation and much of the future demand in these markets will be mainly for replacement of the existing stock. While the Third World offers a large potential market, there is at least a 10- to 15-year gap before this potential will begin to be realized, and current estimates of global capacity and demand predict that supply will exceed demand by up to 15 per cent in 1985. Nor is this a temporary phenomenon as supply is projected to outstrip demand for the rest of the decade.[15] A major share of the global excess capacity is in North America and the major U.S. vehicle companies must not only adjust their product mix but contend with new capacity expansion by their offshore competitors.

At the same time, the U.S. vehicle companies and their parts suppliers are confronted with stiff import competition from Japan. As shown in Table 6, the presence of Japanese vehicles in the North American market is not a recent development.[16] However, the Japanese producers found themselves well situated to meet the changing consumer preferences after the second oil price increase and have been able to capture a major share of both the Canadian and U.S. vehicle markets. More important, the Japanese products are now setting the standards for quality and price in the North American market.[17] The Japanese cost advantage for placing a vehicle at the U.S. border, after all freight, landing, and tariff costs are paid, has been estimated to be as high as $1,750 (U.S.) as compared to a similar North American produced vehicle.[18] Part of this cost advantage is due

TABLE 5
Passenger car sales by size: Canada and the United States

		Small			
		Imports[a]	Domestic (% of sales)	Intermediate domestic	Large domestic
1971	Canada	24	20	22	34
	United States	15	23	21	41
1973	Canada	19	29	25	29
	United States	15	28	24	33
1975	Canada	18	30	25	27
	United States	18	35	24	23
1977	Canada	20	31	26	23
	United States	19	30	26	25
1978	Canada	18	34	27	21
	United States	18	32	27	23
1979	Canada	14	39	25	22
	United States	22	34	24	20
1980	Canada	21	40	25	21
	United States	27	36	21	16
1981	Canada	28	38	20	16
	United States	27	37	20	16
1982	Canada	31	41	20	8
	United States	28	34	19	19

NOTE:
a Until 1979, most imports are small vehicles; after 1979 up to 20 per cent may be intermediate vehicles.
SOURCE: Motor Vehicle Manufacturers Association of Canada.

to the low yen, substantially lower wage rates, and government assistance in Japan. Nevertheless, a major part is explained by higher labour and management productivity, less waste, greater use of automation and new production technologies, effective control of costs, and the stress on quality by the Japanese producers. Moreover, North American consumers have learned since 1979 that Japanese vehicles are high-quality vehicles in terms of fuel efficiency, reliability, maintenance, and performance.

In what has been described as 'the biggest industrial revolution in peacetime history',[19] the North American automotive sector has responded to the Japanese competition with a massive restructuring program to improve products, cost competitiveness, and productivity. As shown in Table 7, automotive capital expenditures in both Canada and the United States have increased dramatically since 1979, and it

TABLE 6
Passenger car sales in Canada and the United States

	Canada					United States				
		Market share					Market share			
	Total sales (unit-thousands)	Domestic	Market U.S. (%)	Japan	Other	Total sales (unit-thousands)	Domestic	Canadian (%)	Japan	Other
1971	781	32.1	43.8	13.7	10.4	10,209	77.6	7.4	5.7	9.3
1972	859	31.0	45.1	13.6	10.3	10,908	77.8	7.7	5.8	8.8
1973	971	32.5	48.1	11.5	7.9	11,402	77.3	7.5	6.5	8.7
1974	943	32.8	51.7	9.3	6.2	8,838	75.5	8.8	6.7	9.0
1975	987	28.0	56.5	9.7	5.8	8,615	72.8	9.0	9.4	8.8
1976	946	25.8	58.0	10.7	5.5	10,098	77.2	8.0	9.2	5.6
1977	991	23.1	57.4	13.6	5.9	11,169	74.0	7.5	12.5	6.0
1978	987	26.5	56.0	11.4	6.1	11,300	75.1	7.3	12.5	5.1
1979	1,003	29.2	56.9	8.0	5.9	10,467	71.8	6.4	17.2	4.6
1980	932	23.2	56.3	14.8	5.7	8,979	66.6	6.7	21.3	5.4
1981	904	18.1	53.5	23.0	5.4	8,532	66.1	6.6	21.8	5.5
1982	713	68.6		25.0	6.4	7,979	72.2		22.6	5.3

SOURCE: Department of Regional Industrial Expansion, Ottawa; *U.S. International Trade Commission* (1983).

TABLE 7
Capital expenditures in Canadian and U.S. automotive industries (millions Canadian dollars)

	1973	1974	1975	1976	1977	1978	1979	1980	1981
Canada									
Motor vehicle manufacturers	43.2	73.5	61.0	59.6	152.5	83.6	111.4	136.4	272.9
Truck body and commercial trailer manufacturers	17.6	31.2	18.5	23.3	24.1	15.4	41.7	47.2	32.2
Motor vehicle parts and accessories manufacturers	78.7	119.9	81.2	62.5	109.6	203.9	330.9	780.9	666.5
TOTAL	139.5	224.6	160.7	145.4	286.2	302.9	484.0	964.5	971.6
United States									
Motor vehicle manufacturers	806.0	1020.0	667.0	1032.2	1922.5	2140.0	2232.4	2678.6	5631.9
Truck and trailers manufacturers	57.5	62.8	61.8	45.1	98.3	89.3	99.7	106.3	119.2
Motor vehicle parts and accessories manufacturers	1420.0	1723.1	1473.3	1273.8	2589.8	3680.6	4108.0	4725.0	5490.1
TOTAL	2283.5	2805.9	2202.1	2351.1	4610.6	5909.9	6440.1	7506.9	1124.2
Canada/U.S. total	2423.0	3030.5	2362.8	2496.5	4896.8	6212.8	6924.1	8471.4	12212.8
Canada as a percentage of total	5.76	7.41	6.80	5.82	5.84	4.90	7.00	11.4	8.00

NOTE:
a Revised in 1977; excludes motor homes; see Appendix 2 in Lavalle-White (1983) for problems with official statistics.
SOURCE: Lavalle-White (1983).

is projected that up to $80 billion (U.S.) will have been spent by 1985 to redesign products, retool parts plants, and rebuild assembly plants. The North American automotive sector has shed over 2 million units of obsolete assembly capacity, converted a considerable amount of parts and assembly capacity to meet current market demands and reduced the break-even point for vehicle production from over 11 million units to under 8.5 million units. The adjustments, moreover, have gone beyond converting capacity and products to involve fundamental changes in product and production technology, supplier-producer relationships, job requirements, management-labour relations, management systems, and corporate strategies.[20]

The need to continually improve cost performance, products, facilities, and organization is now a major characteristic of the automotive market. The international market has become dynamic in terms of competitiveness and to remain competitive, each automotive company must be flexible, adaptive, and innovative. It is argued that North America automotive sector will have to invest an additional $80 billion (U.S.) between 1985 and 1990 just to keep pace with the Japanese producers. Since a major instrument of dynamic competitiveness is technological leadership, a growing share of these capital expenditures will be in research and development. The ability of any automotive firm to remain continually competitive on price and quality will also depend upon staying abreast of technological innovations by its competitors.

As a result of the above developments, the North American automotive market is no longer separate from outside markets or immune from external events and foreign policies. The Canadian and U.S. automotive producers have entered a period of relatively low market growth, stiff foreign competition and ongoing structural adjustments. These factors have redefined the basis of the Canada/United States automotive trade relationship and confronted Canada and the United States with a very different setting for managing the bilateral automotive trade-policy relationship. The international developments have sharpened the differences between the structures of their automotive sectors which, in turn, have intensified the differences in automotive policy approaches.

Since the mid-1970s, the North American production capacity of the Big Three has not grown and the governments in both countries have become preoccupied with the question of where capacity will be converted and where it will be eliminated in North America. This question has been of particular concern to Canada because of the erosion of protection provided by the Canadian conditions under the APTA and the concentration of the Canadian production mix of the Big Three in larger vehicles and parts for larger vehicles. However, policymakers in Canada and the United States have been confronted with a new set of perplexing policy problems as the restructuring process in the North American automotive sector has also involved the closing down of numerous unproductive parts plants by the Big Three, massive layoffs of workers, major wage and nonwage concessions by the UAW, and numerous bankruptcies of small independent parts producers. These policy problems have superimposed themselves on the 'old' bilateral investment issue, further intensifying the bilateral competition for automotive investment.

Although the market remains oligopolistic in nature, the traditional market shares and profit margins of the U.S. vehicle companies and North American independent parts producers have been reduced significantly. This has raised major concerns about the financial health of the North American producers. Between 1980 and 1982, the North American automotive companies experienced massive financial losses, with the Big Three alone losing $4.7 billion (U.S.). While profits have recovered strongly since then, the North American companies remain burdened with heavy debt loads and face major, ongoing investment requirements for both capital equipment and research and development. Given the stiff competition in the automotive market and the risky nature of research and development, neither the Canadian nor the U.S. governments can be assured that even the largest automotive companies will not some day come knocking for a bailout as Chrysler did in 1979.

Canadian and U.S. policymakers also face the distressing problems of structural unemployment and labour adjustment in the automotive sector. Traditionally, this sector has been a major creator of direct and indirect jobs in both countries and, particularly in Canada, it has been used as a policy instrument for job creation. As shown in Table 8, automotive employment fell sharply in both countries after 1979. Despite the rebound in production, automotive unemployment continues to remain high and a major reason is the shift by the automotive companies to more capital-intensive production methods to maximize economies of scale, trim labour costs, and improve produc-

TABLE 8
Production workers in Canadian and U.S. automotive industries (thousands of workers)[a]

	1973	1974	1975	1976	1977	1978	1979	1980	1981
Canada									
Motor vehicle manufacturers	32.8	35.1	31.7	35.1	38.6	37.2	39.0	32.5	32.9
Truck body and commercial trailer manufacturers	6.7	7.2	6.4	6.0	6.0	6.6	7.0	7.4	6.8
Motor vehicle parts and accessories manufacturers	49.1	46.2	39.1	43.9	46.9	53.2	50.6	41.9	45.1
Total	88.6	88.5	77.2	85.0	91.5	97.0	97.6	81.8	84.8
United States									
Motor vehicle manufacturers	309.1	262.2	235.1	273.8	289.9	303.5	292.0	220.6	223.4
Truck bodies and trailers	59.7	52.8	41.2	48.1	63.0	54.5	56.7	47.3	42.9
Motor vehicle parts and accessories manufacturers	600.0	547.2	480.3	550.5	600.5	630.5	597.9	473.6	464.0
Total	968.8	862.2	756.6	872.4	953.4	988.5	946.6	741.5	730.3
Canada/U.S. total	1057.4	950.7	833.8	957.4	1044.9	1085.5	1044.2	823.3	815.1
Canada as a percentage of total	8.38	9.31	9.26	8.88	8.76	8.94	9.35	9.94	10.40

NOTE:
a Revised in 1977; excludes motor homes; see Appendix 2 in Lavalle-White (1983) for problems with official statistics.
SOURCE: Lavalle-White (1983).

tion and product quality. With the need to continually improve competitiveness and productivity, automotive employment and job growth are unlikely to return to their historical levels of the pre-1979 era. Consequently, both governments must contend with continuing demands for job protection and the economic and treasury costs of medium-term labour adjustment.

The global corporate strategies of the Big Three themselves have contributed to the policy problems faced by governments in Canada and the United States. Since the early 1970s, global economic integration and new technologies in production, corporate organization, and communications have created the potential for corporations to organize, plan, source, produce, and distribute on a global basis. The convergence of consumer preferences and the exposure to direct foreign competition have, especially after 1979, spurred the tend to globalized planning and internationalized production by the U.S. vehicle companies. This trend has been further reinforced by their ability to take advantage of such things as differential wage rates, varying pollution laws and differing government incentives and policies when sourcing and investment decisions are made.

A major element of the global corporate strategies of the Big Three is the offshore sourcing of key automotive components and vehicles for the North American market. Currently, offshore sourcing of original equipment parts by the U.S. vehicle companies is relatively minor but it is projected to increase significantly, with possibly as much as 15 per cent of North American assembly needs sourced from abroad by 1995. The Big Three are already sourcing key automotive components from in-house operations located abroad and, under the pressure to improve cost competitiveness and the attraction of foreign policies, they are expanding their offshore capacity. The Big Three have also turned to the offshore vehicle companies to supply parts in order to fill the gaps in their current parts production mix, conserve their scarce financial resources and take advantage of superior technology and quality. As for captive vehicle imports, whether or not these imports are simply being used to fill the gap until North American capacity has adjusted is an open question. While both Ford and Chrysler have decided to directly tackle the small car market with production in North America, GM has chosen to concentrate its own North American production on medium to larger vehicles and import small cars, particularly from the two Japanese companies – Isuzu and Suzuki – in which it has part ownership.

A second important element in the corporate strategies of the Big Three is the establishment of direct links with the major offshore vehicle companies, particularly with the Japanese companies. As part of its overall strategy, GM has entered into a joint venture with Toyota to produce small cars in California. While Ford and Chrysler have strongly contested this particular arrangement, it is representative of the growing interdependence between the major vehicle producers in the world. Ford and Chrysler have also established or are seeking corporate links with the major offshore vehicle companies and the forms of interdependence between the major world vehicle companies include part ownership, joint ventures, parts and vehicle procurement arrangements, and market distribution agreements.[21] This trend not only raises questions about the future degree of competition in the global automotive market but raises concerns that the Big Three will be less inclined to subserve national policy goals and interests in North America.

The policy environment in North America has also been affected by the changing ownership structure of the North American automotive sector. Until recently, offshore ownership was negligible and largely concentrated in the independent parts sub-industry. Since the late 1970s, the major offshore vehicle companies have been establishing their own production facilities in North America and investing in North American parts and material suppliers. Virtually all of this offshore investment has gone to the United States, intensifying Canadian concerns. Volkswagen has established an assembly facility and the Japanese companies have already invested over $1 billion (U.S.) in the United States, including assembly plants by Honda and Nissan. Canada has only attracted a Volkswagen parts plant and a Toyota aluminum wheel rim plant. The increased presence of offshore-owned operations has direct implications for North American automotive production, employment, and trade because the offshore producers rely on direct offshore management control, imported goods and services, and capital-intensive production methods. And at the same time, they have their own governments to please.

Perhaps the most important new factor confronting Canadian and U.S. policymakers is the direct vulnerability of their respective auto motive sectors to the automotive policies in third countries. Foreign protectionism and the management of international automotive trade policies have become important issues for Canada and the United States. The most compelling argument in Canada and the United States for installing higher and more permanent trade protection for the automotive sector is that every other country is already protecting its own domestic sector through export promotion programs, content schemes, import restrictions, subsidies, and other financial assistance, and that, relative to others, Canada and U.S. markets are open automotive markets. Furthermore, every major automotive producing country is burdened with excess production capacity and the favoured policy solution is to promote exports and restrict imports. With access to the European and Japanese markets effectively precluded, the main target is the North American market. The shifting of the excess capacity problem to North America not only exacerbates the current economic problems in the North American automotive sector but places the North American governments under greater political pressures to protect their respective automotive sectors and disrupts both the adjustment process in each country and the bilateral automotive trade policy relationship. At the same time, automotive producers in North America are now developing products, particularly parts, that can begin to compete in offshore markets. To the degree North American products can potentially compete in offshore markets, the management of international automotive trade policy relations becomes an even more important factor for the North American governments.

Superimposed on the above automotive policy issues for Canada and the United States is the great uncertainty surrounding the future shape and prospects of the North American automotive sector. While Chrysler has rebounded from near bankruptcy, numerous North American automotive companies, both small and large, remain burdened by heavy debt loads, obsolete products, excess capacity, and limited research and development capabilities. Should the economic recovery stumble or foreign competition intensify, then both countries could find themselves confronted with a second wave of company crises and massive layoffs. The recent decline in the price of gasoline has helped to rejuvenate the North American automotive sector and the Big Three are currently confronted by supply shortages in larger vehicles and excess capacity in small vehicles. Yet, with the high costs and long lead times to develop and produce a new product, corporate and government policymakers cannot discount the possibility of further disruptive oil price swings. These types of uncertainties are now governing the bilateral automotive trade policy relationship and the uncertainty surrounding the future course of this relationship has been further heightened by the unilateral response of each country to the economic problems in it own automotive sector and the direct but asymmetrical competition between Canada and the United States for automotive investment.

UNILATERAL RESPONSES AND BILATERAL PROBLEMS

Both Canada and the United States have responded unilaterally to the problems of low production, high unemployment, and rising imports in their respective automotive sectors, and bilateral consultations on numerous substantive issues have been at a minimum. The United States has pursued a strategy that is increasingly independent of the bilateral approach in the APTA (Perry 1982, 72). This is evident by the negotiation of the original three-year automobile export restraint arrangement with Japan in 1981, the subsequent one-year extension of this arrangement for 1984, and the unilateral increase in the tariff on light trucks from 4 per cent to 25 per cent. The administration has actively solicited automotive investment from abroad through direct suasion and the creation of free trade zones, and state and municipal governments have provided locational incentives to both offshore and U.S. companies.

Canada has also pursued a unilateral course, negotiating its own export restraint arrangements with Japan in each year since 1981 and actively seeking offshore investment and foreign procurement of Canadian parts. However, Canada has found itself with little room to manœuvre because of the dependence of the domestic automotive sector on the U.S. automotive sector. Nor has the United States refrained from directly interfering in Canadian automotive policies. This was aptly demonstrated in 1979 when the United State provided an unprecedented aid package to Chrysler and Canadian authorities had no choice but to offer a measure of support to Chrysler Canada, as the U.S. authorities made it quite clear that their support for Chrysler depended on Canada's making a similar gesture (Grey 1981, 57).

The similarity in unilateral policy responses to date is overshadowed by the divergence in views about the future prospects of their domestic automotive sectors and the proper course of policy. The Reagan administration has signalled a return to a noninterventionist policy and has stated it confidence that the U.S. automotive sector has the capability and resources to regain its traditional viability and robustness. The administration appears to have quietly accepted the corporate strategies of the Big Three to source more parts and vehicles from offshore and to enter into joint ventures with the major offshore vehicle companies. Nor does it appear to be concerned with the increase in foreign ownership in the U.S. automotive sector. While a number of labour adjustment programs have been introduced, the administration has accepted the massive layoffs and the major concessions by the UAW as part of the adjustment process.

The Canadian federal government, on the other hand, is deeply concerned about both the future of the Canadian automotive sector and the limitations on its own policy options. The low research and development base, the concentration on labour-intensive activities, assembly operations, and production of larger vehicles and related parts, the weak competitive structure of the parts industry, and the dependence on the U.S. automotive market combine to make the Canadian automotive sector highly vulnerable to external economic developments. At the same time, the Canadian safeguards and commitments under the APTA provide minimum protection against the externally induced economic developments in the North American automotive sector. Canadian policymakers are painfully aware that either the Big Three or the U.S. government could leave Canada out of their policy decisions and that Canada has few levers to influence the trade and investment decisions of the major offshore vehicle companies. Confronted with hostile ears in Washington and unsympathetic ears in Japan, the Canadian dilemma is that the following prediction might come true:

> It is now fairly obvious that by 1985 Japan and the United States will have their own 'Autopact', (based more on the politics than the economics of trade), and that the North American Autopact could become moribund (Hay and Sulzenko 1982, 478).

Within this unsettled bilateral environment, four major trade policy issues have emerged on the bilateral automotive trade policy agenda. The first concerns the future of the APTA. Whether or not the APTA should be quietly retired is a silent but festering question. Not only has it not proven useful in dealing with the economic problems and bilateral policy issues arising from the international developments, but these developments have intensified the policy gulf between the two governments' positions on the APTA. To the extent that it continues to provide a relatively stable bilateral trade environment for the U.S. vehicle companies and some assurances to Canada that it will not be left out of the corporate strategies of these companies or the policies of the U.S. government, then the APTA continues to play a mutually useful if limited role. However, to the extent that it interferes with the structural adjustment of the North American automotive sector, limits or threatens the policy interests of either country and/or continues to plague the bilateral automotive trade policy relationship, then its ongoing usefulness, indeed its continued desirability, is questionable.

The future of the APTA is now largely tied to the outcome of the restructuring of the North American automotive industry; however, the other three major automotive trade policy issues could force the APTA to the top of the bilateral automotive trade agenda at any time. An important issue that Canada and the United States have yet to deal with is the treatment of cross-border trade in parts and vehicles produced in North America by the major offshore vehicle companies. Although little such trade occurs today, it nevertheless has the potential to grow significantly as the offshore companies expand their North American operations. This issue involves several elements, including the treatment of Japanese vehicles produced in North America should the export restraint arrangements continue after 1984. It is a particularly important issue for Canada because of the desire for offshore automotive investment in Canada and for access to the U.S. operations of the offshore companies for the Canadian small independent parts producers. While most U.S. automotive tariffs are already negligible, Canada's ability to attract offshore automotive investment, particularly in major automotive components and vehicle assembly, is dependent on providing assured and predictable access to the larger U.S market. The APTA offers bilateral duty-free trade but it does not appeal to the offshore producers because of the small Canadian market, the Canadian safeguards and commitments, the disenchantment of the United States with the APTA, and the political uncertainties in Washington over the future course of U.S. automotive trade policy.

The third major bilateral trade-policy issue is the use of subsidies to attract new automotive investment and to protect existing automotive facilities. The issue emerged after the first oil price increase when Canada and the United States started to compete for investment by the Big Three. The U.S. northern states began offering locational incentives in the mid-1970s and Canadian governments soon followed with their own locational incentives. In 1978, the subsidy bidding war erupted into a major bilateral dispute when the Canadian federal government and the Ontario provincial government outbid the Ohio state government for a Ford engine plant (see Leyton-Brown 1979/80). While both federal governments subsequently renounced the desirability of competing with locational incentives, neither national government has renounced the option of using such subsidies.

Since 1978, the subsidy bidding has expanded to competing for offshore investment. The U.S. states have actively sought Japanese offshore investment, and Volkswagen, Nissan, and Honda have been provided with capital grants, low interest loans, and property tax abatements. Canada has responded with duty remission programs and other subsidies but has yet to attract a major offshore-owned parts facility or assembly plant. Both the U.S. and offshore vehicle companies have taken advantage of the free-trade zones in the United States and governments in Canada and the United States have continued to offer subsidies to the Big Three to maintain parts production in their respective jurisdictions. At the same time, Canada has supported its independent parts producers with subsidies for capital investment and research and development, and since 1981, about 35 million (Cdn.) has been directed to these producers, with over 70 per cent of this amount going to the small independent parts producers.

It is ironic that the growing use of subsidies to attract investment may result in a similar border trade war that led to the signing of the APTA in 1965. With the U.S. market as the main destination, any subsidized producer in Canada faces the possibility of finding himself confronted by a countervail petition in the United States. This threat is a major factor in the disinclination of the offshore producers to invest in Canada. The U.S. administration has already expressed strong criticism of Canada's duty remission program for Volkswagen and the possibility of a second major border war over automotive trade cannot be discounted. Nevertheless, as U.S. policies, including the threat of stronger trade restrictions, continue to attract offshore investment into the United States, the U.S. administration cannot expect Canada to sit back and watch. In many respects, the actions and rhetoric in the United States are similar to those in the mid-1970s when the Japanese television producers were 'persuaded' to establish facilities to produce Japanese televisions in the United States.[22]

The fourth major trade policy issue involves the question of what to do about direct Japanese import competition. This is probably the most potentially contentious issue facing the bilateral trade policy relationship because whatever action is taken against Japan by one country will directly affect the automotive interests of the other country. Both federal governments are confronted with rising political demands to protect their respective automotive sectors and the current demands are not for temporary relief from imports but for outright permanent trade protection.[23] The trade policy question is relatively straightforward for Canada and the United States: should the governments actively intervene and protect their domestic automotive companies and employees or should they resist the protectionist demands and let market forces operate? There are two dimensions to this question. Canada and the United States can choose to join together and either form a continental barrier or jointly resist trade protection and manage the adjustment process at the continental level. Alternatively, each country could choose its own route. However, should both decide to go in opposite directions, this is likely to impose a major strain on the overall bilateral economic relationship.

CONTENT

The current automotive trade policy debates in Canada and the United States are dominated by the proposal to institute domestic content regulations. The proposals in Canada and the United States share the common objective that companies selling in the domestic market should produce in that market. If passed, the current U.S. proposal in the Congress, The Fair Practices in Automotive Products Act, would require each company selling more than 100,000 units in the U.S. market to achieve an increasing percentage of U.S. content as that company's sales increase. The maximum content percentage would be 90 per cent when a company's sales exceed 900,000 vehicles.

This bill is strongly supported by the UAW and it has been passed by the House of Representatives in the last two sessions of the Congress. The bill does not appear to have enough support in the Senate and President Reagan has stated publicly that he will veto the bill. The major U.S. vehicle producers are split on the issue. Ford and Chrysler do not oppose the bill. GM continues to oppose the bill, partly because of its own strategy to use Japanese imports to fill part of the gap in its small car fleet.

The Canadian proposal, as outlined in Lavalle-White (1983), would require any company selling between 3,000 and 28,000 vehicles in Canada to meet a base amount of Canadian content plus a designated percentage for each 1,000 sales in excess of 3,000 units. These companies would have their duty on imports reduced proportionately as their level of Canadian content increases and would enjoy duty-free entry once their Canadian content reached 85 per cent. A company selling over 28,000 would be required to meet commitments similar to those in the APTA, including the production-to-sales ratio and the Canadian content conditions, but would enjoy duty-free entry. In an effort to further protect automotive sector jobs in general and the Canadian parts industry in particular, especially the small independent parts producers, the commitments would be increased through direct company-to-government negotiations once all companies have met the initial commitments. The Canadian federal government has yet to take a position on the content proposal, partly because it is waiting for the responses of the Japanese companies to recent inquiries about possible Japanese automotive investment in Canada and Japanese procurement of Canadian parts. As expected, the proposal is strongly supported by the UAW and the Canadian independent parts producers. What is particularly interesting is that the proposal is also supported by the Big Three.

Since the Canadian and U.S. automotive tariffs are ineffective inducements to meet the content requirements, both proposals rely on quantitative restraints which would embargo imports above the threshold level unless the content requirements are met. The quantitative restraints would reduce the direct competition from offshore. The domestic content requirements would, in turn, restrict the use of parts produced offshore, be they imported by the Big Three or by the offshore companies. While neither proposal names individual com panies and details on how the content programs would be administered are scarce, the Canadian and U.S. content proposals are directly aimed at the Japanese vehicle companies. The U.S. vehicle companies are currently in a position to meet the requirements of both the Canadian and U.S. proposals. Most European companies do not import quantities significantly above the proposed threshold levels and have existing North American production facilities to fill any required domestic content. Consequently, both proposals in effect discriminate only against Japanese producers. In short, they are designed to limit Japanese import competition and induce Japanese automotive investment into each country.

A content law in the United States would substantially reduce the pressures on the U.S. automotive sector to adjust to the economic changes in the global automotive market. It would enable the Big Three to regain their market power in the U.S. market and, at the same time, provide them with a degree of monopsony power to purchase vehicles from the offshore producers to fill their vehicle fleets. While the Japanese companies could reduce the burden of the content requirements by locating higher-valued vehicle and parts production in North America, they would be forced to shift a significant portion of their export production to the United States and to accept the higher costs of producing and sourcing in the United States. U.S. automotive workers would receive job protection either in Japanese-owned or U.S.-owned assembly plants, but these gains would be less than expected because of the use of more capital-intensive assembly methods. Above all, the content proposals would provide direct protection to production and employment in the parts industry from offshore sourcing by both the U.S. and Japanese companies.[24]

As a package, the U.S. content proposal is outright protection which would directly benefit the U.S. automotive producers at a direct cost to the national economy from higher consumer prices, narrower consumer choice, inefficient production and a misallocation of resources. Moreover, the U.S. major trading partners, particularly Japan, could be expected to retaliate or to demand hefty compensation, directly affecting the economic and trade interests of other U.S. sectors. As a U.S. content law would be a major blow to the already fragile GATT system, these costs could multiply rapidly if a content law leads to a major trade war affecting the broad range of U.S. multilateral interests.

A Canadian content law would impose similar economic costs on the Canadian economy. However, the trade protection benefits to the Canadian automotive sector could also be negative. To meet the requirements of the Canadian content proposal, a company would have to rely on exports in order to be able to run its plants above the minimum scale production levels. The sponsors of the Canadian proposal have cast it as simply an extension of the APTA. However, unlike the APTA, the current Canadian proposal is not voluntary and, more important, does not offer either access to foreign markets or potential increases in economic efficiency from product rationalization and large-scale production. If a parallel to the APTA is to be drawn, it is that the benefits of the Canadian content proposal to the domestic automotive sector are dependent on what the United States does. This raises two questions: will the United States implement a content law, and how will the United States react to a Canadian content law?

With respect to the possible enactment of a Canadian content law, three outcomes seem certain. First, the passage of a Canadian content proposal may provide some short-term protection but it is unlikely to provide long-term protection or solve the structural problems in the Canadian automotive sector, particularly those of the parts industry. Second, regardless of whether or not the United States passes a content law, similar legislation in Canada is very unlikely to induce the desired wave of offshore investment into Canada; to the extent that some offshore companies establish minor facilities to raise their quota limits, Canada might gain a marginal amount of offshore investment. Third, a Canadian content law will cause a major disruption in the bilateral trade policy relationship, unless it is the United States which acts first to institute domestic content legislation.

Should the United States pass content law, Canada is certain to follow with its own version.[25] This would be seen as the only way to protect the Canadian automotive sector. While the current U.S. content proposal does not give special provisions for Canada, the Big Three are currently able to meet the requirements of both the Canadian and U.S. proposals and, with content laws in both countries, the Canadian automotive sector would share in the protection of the U.S. market as well as receive protection from offshore competition in its own market. Since exports to the United States of products produced in Canada by offshore companies would be effectively precluded by a U.S. content law, little if any offshore investment would materialize and the Canadian automotive sector would continue to be dominated by the Big Three.

However, the Canadian automotive sector would likely face a medium-term period of structural decline. With content requirements in the United States, the Big Three are unlikely to operate significantly above the Canadian requirements. Their future investment would probably be concentrated in assembly and some of the companies might further reduce their parts production. At the same time, the small Canadian independent parts producers would be squeezed out of the U.S. market as the Big Three substituted U.S. or offshore parts for Canadian parts to optimize their offshore sourcing of parts and vehicles. Nor should Canada expect to be able to raise the commitments of the Big Three. The medium-term policy problem would be to hold the Big Three at the current commitments and to avoid the situation where a company misses its annual commitment and thus confronts Canada with the dilemma of having to impose the quota. Indeed, the Canadian federal government could not discount the possibility that the Big Three could decide at some time down the road that the Canadian content law no longer suits their interests, and Canada could be confronted by a collective demand to lower the commitments.

The only scenario which might provide medium- as well as short-term protection to the Canadian automotive sector is the enactment of content law in both countries with a provision in the U.S. legislation that Canadian content qualifies as 'U.S. content'. While the Congress is very unlikely to accept this provision, a U.S. administration might be convinced that it is warranted in order to protect existing U.S. interests in the Canadian automotive sector. A North American content barrier would not lead to a solution of the structural problems in the Canadian automotive sector. At best, it would preserve the current structure of the Canadian automotive sector and the North American pattern of production, investment, and trade. As for Japanese investment in Canada to get under the North American content wall, there would be little likelihood of significant Japanese investment because the Japanese producers would, like the Big Three, be very mindful that the United States could remove the Canadian provision at any time.

The Reagan administration has stated its strong opposition to the proposed U.S. content bill. It has expressed the view that such a bill would be inconsistent with the provisions of the GATT and would lead to retaliation by U.S. trading partners which would threaten the broad range of U.S. multilateral trade and foreign investment interests. This raises the major question of what would happen if Canada unilaterally passed a content law, especially during the policy deliberation process currently underway in the United States. Given the current state of the automotive sector and the medium-term importance of this sector to the Canadian economy, the Canadian federal government may feel compelled to act. With the effectiveness of the APTA diluted and little prospect for significant Japanese automotive investment, the Canadian federal government may decide to take its chances and accept the inevitable economic costs on the grounds of national sovereignty and industrial and technological imperatives.

This unilateral act by Canada is certain to cause a major disruption in the bilateral economic relationship. Not only would the Canadian content law directly affect U.S. automotive interests but it could adversely affect U.S. multilateral interests and the current initiatives of the Reagan administration at the GATT. The administration has set the further liberalization of international trade and investment as a major cornerstone of its overall economic policy. It is quite improbable that the administration would tolerate a protectionist act by its largest trading partner which could disrupt its current multilateral initiatives and set a precedent for other countries. Moreover, the administration would be compelled to react strongly because of the perception that the Canadian content law could be followed by similar performance requirements in other sectors. This perception underscored the strong U.S. reaction to the National Energy Program, and a Canadian content law would be interpreted as further evidence of Canadian industrial policies that directly affect the bilateral as well as the multilateral interests of the United States. The only factor which might temper or delay retaliation by the administration would be the difficulties in formulating an action that would sufficiently hurt Canadian interests without substantially harming the interests of the Big Three.

The Canadian content law would not attract offshore investment because of the high probability of U.S. retaliation. Nor would the administration be likely to accept 'content induced' exports of offshore products from Canada. Its strong opposition to the current Canadian commitments under the APTA and Canada's duty remission programs make this clear. Moreover, certain members of the U.S. Congress would probably attempt to use the Canadian content law as a precedent to persuade the administration to accept a U.S. content law and, at the same time, disregard Canadian concerns and interests. Canada might very well find itself confronted by both a U.S. content law and trade retaliation throughout the international trading system, as well as no major Japanese facilities located in its territories.

That a content proposal is under serious consideration in Canada despite the above potential consequences reflects the grave concerns about the future of the Canadian automotive sector. Nor are these concerns alleviated by U.S. free-trade rhetoric when both the U.S. federal and junior governments are actively soliciting Japanese automotive investment. The Canadian federal government has little desire to legislate mandatory content requirements; however, as indicated in the recent Throne Speech, it intends to deal with the medium-term problems of the Canadian automotive sector and to address directly the issue of Japanese investment:

> The automobile industry is crucial to our economic well-being. Stabilizing employment in automobile manufacturing and its supplier industries is an essential task. The Government intends to seek a Canada-Japan Auto Agreement for the benefit of both countries, leading to additional production facilities and parts procurement in Canada.[26]

The success of Canadian domestic policies to improve the performance and development of the Canadian automotive sector, as well as the outcome of any bilateral automotive negotiations with Japan, will depend largely on the policies and actions of the United States. Numerous U.S. officials and commentators have explained the recent wave of Japanese investment as the exploitation of profitable opportunities in the United States. Notwithstanding the fact that the Japanese companies would prefer to export their products as opposed to their plants, there is no reason to expect Canadian locations to be any less profitable if allowed to serve the North American market. The profitability of the Canadian operations of the Big Three are evidence of this. The United States cannot expect to have it both ways; however, it is clear that whatever the United States does, it will be a long-term commitment which will set both the future development of the Canadian automotive sector and the courses of bilateral automotive trade policy relations.

SUMMARY

Since 1965, three key developments have shaped Canada/United States automotive trade and trade policy issues. The first was the signing of the APTA. This trade agreement has established the production and distribution structures of the Canadian automotive sector and the patterns of North American production, trade, and investment. The second development was the growing dependency on trade and the changing global political-economic position of the United States during the 1970s and into the 1980s. This development has directly affected the underlying basis of the Canada/United States economic relationship and consequently both the substance and the management of bilateral automotive trade relationships. The third development was the dramatic changes in the international automotive market since the early 1970s which have exposed the North American automotive producers to direct import competition in their home markets. These changes have invalidated the basic premises underlying the APTA and have demanded major structural adjustments in the Canadian and U.S. automotive sectors.

The international developments have not only altered the economic environment in which the bilateral automotive trade relationship is conducted but they have also confronted Canadian and U.S. policy-makers with a new set of perplexing automotive policy problems. These policy problems and the changing economic structures of the North American automotive sector have sharpened the differences in the policy approaches of the Canadian and U.S. federal governments. Despite its recent protectionist policies, the Reagan administration has signalled a return to the traditional U.S. automotive policy of nonintervention and liberalized trade, and it has expressed its confidence that the U.S. automotive sector has the resources and capabilities to successfully adjust to the changes to the international automotive market and regain its viability and robustness. Canada, which has also imposed trade barriers against Japanese automobile imports, has, on the other hand, become increasingly concerned about both the future prospects of its automotive sector and the limitations on its policy options. The protection provided to the Canadian automotive sector under the APTA has eroded and Canadian policymakers are painfully aware of their weak position in influencing the trade and investment decisions of both the U.S. vehicle companies and the offshore vehicle companies.

Within this unsettled environment, four issues have come to dominate the automotive trade policy agenda. Both countries continue to disagree over the retention of the Canadian safeguards and commitments under the APTA, and the desirability of the continuation of the APTA is now a silent but festering question. At the same time, Canada and the United States are directly competing for automotive investment by the U.S. vehicle companies and the offshore vehicle companies, particularly the Japanese companies. To attract automotive investment, governments in both countries have provided a variety of subsidies and the use of locational incentives raises special problems for Canada because of the vulnerability of subsidized Canadian automotive exports to U.S. countervail actions. Underlying the issue of subsidies is the treatment of intracontinental trade in offshore products produced in North America. Again this is a particularly important question for Canada as its ability to attract Japanese offshore investment is dependent on predictable and unhindered access to the U.S. market. Superimposed on these bilateral trade policy issues are the current proposals in Canada and the United States to legislate domestic content requirements in their respective automotive markets. Both proposals, if passed, would not only impose direct economic costs on their own economies but would also directly affect the automotive interests of the other country and further disrupt the bilateral automotive trade relationship.

In addition to these bilateral automotive trade policy issues a broader issue arises concerning the effect of each government's policy responses to the problems in the automotive sector on the general bilateral relationship. The automotive sector is at the forefront of the economic and political economic challenges posed for North America by the integration of global economy activity and internationalized production. How each country addresses its domestic automotive problems, and the response by the other, will likely set the tone and nature of the broader economic relationship in the years to come.

NOTES

1 Readers are asked to go through the table as the information relates directly to the discussions in the text.

2 For purposes of clarity, automotive sector refers to all industries which produce automotive parts and vehicles. Those industries producing automotive components are referred to as the parts industry while industries producing vehicles are referred to as the vehicle or assembly industry.

3 U.S. Department of Commerce (1983) is actually the third in a series of studies undertaken by the U.S. government on the U.S. automotive study. The two other studies are the U.S. Department of Transportation (1981) and U.S. Department of Transportation (1982), and the three studies were commissioned in the wake of the Chrysler bailout. Lavalle-White (1983) was commissioned by the federal government of Canada in response to growing political demands to address the economic problems in the Canadian automotive industry. The commissioning of task force studies on the automotive industry is a long-held tradition in Canada which seems to have gained popularity in the United States.

4 It has been estimated in econometric simulations with the CANDIDE 1.2 M model at the Economic Council of Canada that real domestic product (RDP) in Canadian automotive assembly and parts were higher by over 100 per cent and 30 per cent respectively between 1965 and 1976 as a result of the APTA. It is further estimated that real GNP was higher by $1.5-2.0 billion (1961 dollars) in each year after 1970. The simulations also indicate that the APTA has affected the structure of the Canadian economy in four ways. First, the APTA has increased both the linkage and sensitivity of the Canadian macroeconomy to the cyclical conditions in the U.S. automotive market. Second, other Canadian manufacturing sectors are less competitive because of the economy-wide spread of higher real wages induced by the real wage increase in the automotive sector. Third, a number of important Canadian non-automotive manufacturing sectors such as iron and steel and metal fabricating have become significantly more dependent on the automotive sector. Fourth, the benefits of the APTA have been concentrated in Ontario and the above three factors may have induced net losses to some of the other provinces. See Martin and Moroz (1979) and Moroz (1978).

5 Throughout the years, numerous technical issues have arisen concerning the statistical measuring and reporting of bilateral automotive trade flows. Most of these have been resolved; however, both countries have continued to interpret the trade statistics to its own advantage in arguing its unilateral interests.

6 Certain specialized vehicles and aftermarket parts were not included in the APTA. Aftermarket parts were excluded on

Canada's insistence as the federal government wanted to protect the domestic aftermarket parts market for the independent parts producers.

7 As many U.S. and Canadian analysts have pointed out, most of the original equipment parts imported into Canada are re-exported back to the United States inside vehicles. Canada also exports and imports automotive products to offshore markets under the APTA and these trade flows between the Canadian and offshore operations of the Big Three are shown in Table 2.

8 The conditions specified by the United States in the APTA were that only vehicles and original equipment parts from Canada with at least 50 per cent North American content were eligible for duty-free access and that only designated manufacturers of vehicles in the United States could import original equipment parts duty-free from Canada. While the APTA has induced a marginal shift of automotive production activity from the United States to Canada, the U.S. automotive sector has gained from higher profits, more efficient production in Canada, and a larger production base over which to spread management, R&D, and engineering service costs. The U.S. economy has also directly benefited from higher non-automotive net exports to Canada due to the increase in Canadian real incomes and the reduction in Canadian competitiveness in non-automotive sectors. (See footnote 4.)

9 The second safeguard determines that assembly will be the main automotive activity in Canada. The U.S. automobile companies have made the corporate decision, based on economies and politics, to use mostly imported parts in the assembly of vehicles in Canada. This basic pattern of production and trade is partially amended by the Canadian value-added (CVA) requirements specified in the third safeguard and the two commitments. Since the CVA requirements do not have to be met inside vehicles produced in Canada, each U.S. assembly company has the option to substitute CVA in parts exported to the United States for CVA in vehicles produced in Canada. This flexibility of meeting the CVA requirements has also allowed the U.S. companies to substitute parts exports for vehicle exports, which partly explains why the margin between the actual and the required production-to-sales ratio declined from 1968 to 1981. (See Table 4.)

10 The ratio is calculated in terms of net sales. The required ratio for each company is confidential, but as an industry, the specified ratio for cars ranges from .95 to 1.0; for commercial vehicles from .75 to 1.0+; and for buses from .85 to 1.0.

11 This implicit subsidy financed the conversion of the Canadian facilities of the Big Three and allowed them to cross-subsidize their parts and vehicle exports to the United States including those parts purchased from the small independent producers to fill the content requirements under the APTA. In 1965, the Canadian tariff rate was 17.5 per cent, Canadian wages were 30 per cent lower than in the United States and the Canadian dollar was worth 92 cents U.S. The elimination of the Canadian tariff on imports from the United States plus the major cost reductions allowed by shifting to scale production were not fully passed on to the Canadian consumer.

12 A number of analysts have suggested that Canada's best option to deal with the offshore problem would be to negotiate in the GATT an increase in the upper bounds of the Canadian automotive tariff rates. The objective of the proposal is to recreate the implicit subsidy by once again allowing prices charged to consumers to exceed the costs of imports. Of course, any company wishing to exploit such rents would have to accept the conditions under the APTA.

13 Had this arrangement not been made, Ford would have been required under the APTA to pay duty on all of its 1979 imports. The only 'threat' that the Canadian government has to induce Big Three to comply to the conditions of the APTA is to remove a company from the eligibility list and charge duty on its imports. However, given the importance of any one of the Big Three, this is a risky 'threat'. In the past, the companies themselves have paid duty on some of their imports to avoid having these included in sales and content calculations for APTA purposes. For the Ford case, see Department of Industry, Trade and Commerce (5 January 1981), New Front Wheel Drive to be Assembled in Canada as a Result of Limited Adjustments to Ford Company Production Ratio. Press Release, Ottawa.

14 It is worth remembering that for the United States, the negotiating of the APTA was a damage control exercise which it entered on the grounds of overall national interest and to divert a border trade war in the middle of the Kennedy Round negotiations and defuse growing economic nationalism in Canada. The Letters of Undertaking was initially treated by the U.S. administration as a private arrangement between the U.S. vehicle companies and the Canadian government.

15 See U.S. Department of Commerce (1983) and U.S. Department of Transportation (1981) for discussion of future supply and demand trends.

16 Japanese automobile imports began to capture a significant share of the North American automobile market in the late 1960s. The U.S. vehicle companies first largely ignored the small car market and, after the first oil price increase concentrated on maintaining their overall market share as opposed to competing head on in the small car market. The second oil price jump in 1979 exposed the U.S. vehicle companies to direct Japanese competition as the Japanese producers found themselves well situated to meet the rapidly changing consumer demands.

17 As Japanese imports are the visible cause of the problems in the North American automotive sector, a great deal of accusatory attention has been directed to the trade practices of the Japanese producers and the support provided to them by the Japanese government. However, accusations have also been directed against the North American automotive sector and its governments. Much blame has been placed on high wages, oligopolistic practices of companies and inappropriate government regulations in North America. Macroeconomic forces such as high interest rates, low national demand, and high exchange rates have also received their share of the blame. Nevertheless, the adjustment problem in the automotive sector is essentially microeconomic, requiring the North American sector to adjust to the new market conditions and match the cost and quality competitiveness of the Japan automotive producers.

18 See U.S. Department of Commerce (1983) and Perry (1982) for various cost advantage calculations.

19 Kenneth Harrigan, President of the Ford Motor Co. of Canada Ltd., reported in the Financial Times of Canada, 24 October 1983.

20 For a full discussion of the changes in the North American automotive sector the corporate strategies and internationalized production, see Cohen (1982), Cole and Hervey (1982), Perry (1982), and U.S. Department of Commerce (1983).

21 For example, Ford owns 24.4 per cent of Toyo Kogyo; Nissan is building the Volkswagen Santana in Japan; and Chrysler not only owns 15 per cent of Mitsubishi, but sources engines from the Japanese producer and is for the moment the sole distributor of Mitsubishi vehicles in North America. For a listing of the corporate linkages, see Appendix 7 in Lavalle-White (1983).

22 For a discussion of the events surrounding Japanese television investment in the United States, see Hay and Hill (1978).

23 The United States has publicly stated that the restraint arrangement is a temporary measure yet, before the original three-year arrangement had expired it negotiated a one-year extension for

1984. The Canadian government has said little publicly as to its future intentions but is almost certain to seek an extension of the current arrangement before it expires in March 1984.

24 It is estimated by Wharton (1983) that the U.S. content bill would increase U.S. automotive employment by 39,000 by 1986, or 4.3 per cent of the 1981 automotive work force. U.S. employment is estimated to be higher by 84,000 by 1991, or 9.2 per cent of the 1981 work force as a result of a content law passed in 1982. White-Lavalle (1983) argue that a Canadian content bill would provide 40,000 automotive jobs, or 36.7 per cent of the 1981 automotive work force, plus an additional 40,000 indirect jobs.

25 Should the United States pass a content law, it would not, for all intents and purposes, matter if Canada imposed current regulations as it would get caught in the crossfire. There is also cause for Canadian worry across the entire range of bilateral manufacture goods trade if the United States passes a content bill. Canada could very well find itself facing similar legislation without a wide range of goods, including defence goods now exported under the Canada/United States Production Sharing Agreement. Moreover, content legislation in private-sector markets would likely preclude Canadian access to public-sector goods markets where Canada hopes to reduce the current U.S. government obstacles.

26 Speech from the Throne to open the Second Session 32nd Parliament of Canada, 7 December 1983, Ottawa.

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Comments

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The thesis deserves attention that the Automotive Products Trade Agreement of 1965 (APTA) setting up a limited free trade are between the U.S. and Canada is now no longer effective and should be done away with. In the face of appreciably greater manufacturing cost advantage on the part of the Japanese, compared with North American producers, the reduced Tokyo Round tariffs provide little implicit subsidy for recognized manufactures inside the Agreement. Instead, Japanese vehicles can enter Canada (subject to current Voluntary Export Restraints) and be highly competitive in both quality and price with North American built products leading to recommendations of the Lavalle-White report that the APTA content requirements be applied to foreign imports as well. Thus one of the original reasons for APTA no longer is of consequence. More important is the question whether the existence of APTA is preventing Canada from becoming a part of the 'new' North American automotive industry and is indeed making it impossible to conduct an independent national automotive policy. For that matter, Canadian economic policy in general is sometimes said to be a captive of APTA since the automotive industry is Canada's largest industrial employer and whatever is attempted will create a problem for the auto industry because of the APTA arrangement. What are the views below the border by automotive industry observers?

It is generally felt by the U.S. companies that APTA has worked will and there are few major suggestions for modification of the relationships dictating conditions of Canada/U.S. trade. The real con cern lies outside of Canada/U.S. relations *per se* but rather in that the advantages for manufacturers on both sides of the border visualized in APTA are disappearing as a result of the coincidence of three forces – Toyko Round tariff reductions, the onset of sharply lower cost and well designed passenger cars from Japan, and the ever present threat that U.S. legislation could block out Canadian production by narrowly defined local content laws.

At the same time the major companies are becoming aware that the Japanese import situation in Canada is more complicated than it is in the U.S. because of political tensions within Canada. While the U.S. corporate headquarters are well aware of the cross currents both in Canada and between Ottawa and Washington, there is considerable disposition to follow the Canadian subsidiaries' lead on these matters.

Within the U.S. government there is likewise reluctance to get involved in the nitty-gritty of Canadian automotive policy. There has been roughly a 360 degree change in the Washington attitude in the last four years. Through the decade of the 1970s, APTA had been the best practical example of the benefits that could be derived from sectoral free trade. However, only partly by coincidence, with the arrival of the new Administration, the U.S. began a drive against local content and export requirements of foreign countries which was largely directed at developing countries but which also caught APTA in its web. The drive, which although having labour support was largely fueled by the trade professionals, has gradually become muted as realization has grown that to declare war against existing performance requirements was likely to be injurious to the interests of the U.S. What remains in Washington of the energy directed against performance requirements is largely directed against the imposition of new or more stringent measures.

It is probably fair to say the U.S. Administration would be upset if there were to be a tightening of the APTA requirements on existing firms, but it has chosen to regard Lavalle-White at this stage as a Canadian domestic issue and therefore not fair game for cross-border comment. Instead, the focus of Washington concern is upon the concept of applying the APTA production-sales ratio and CVA requirements to Japanese imports, because such a measure might undermine the Administration's efforts to head off Congressional local content legislation which would certainly be justified by Congress as fair when 'even Canada adopts such a system'. The U.S. companies would like to see the two issues, U.S. local content, and the Canadian extension of APTA requirements to Japanese companies, kept separate.

The most mixed-up problem in the Washington-Detroit-Ottawa automotive axis involves the tentative attempts to get a joint policy toward Japanese imports, which the U.S. has had to avoid because of the attempt to maintain that Japanese export restraints are voluntary. Maintenance of this concept is a strong test of APTA as a limited sectoral free trade area between two countries with independent automotive policies and invariably creates strains on the relationship.

Within the U.S. automotive industry, of course, there are widely varying views of the Japanese problem. Most of the companies advocate measures to moderate Japanese imports. However, the largest company, General Motors, recognizing that adapting to international competition has an international dimension through possible usefulness of imports of small cars and components, strives to avoid a doctrinaire protectionist approach. The industry in the U.S. largely sees application of APTA rules for Japanese imports as justified on the ground of equity for existing investors in Canada. While there are varying degrees of belief in specific regulations, there is general agreement that 'those that sell in a market have an obligation to produce, provide employment, and pay taxes in that market'.

The current view that APTA prevents Canada from adopting a more activist automotive policy deserves comment. At this writing only three out of seven countries, which have pursued identifiable activist automotive policies as part of general growth programs (Japan, Brazil and Spain), can be considered successful in that they are producing substantially ahead of their own domestic markets. Other countries such as Sweden have a major automotive export industry but not as a result of an active automotive policy. In each case at the time the policy was initiated the country was in a truly high-growth, developing state with a relatively docile consumer body and low labour costs. In each case protection played a crucial role in creating the industry. There may be difficulty in determining what an activist automobile policy for Canada should be, but the concept that it could become a new engine of growth for Canada is undoubtedly excessively ambitious. While the idea that Canada should use tactics to get a 'proper' share of Japanese automotive investments going into the North American market is less pretentious, APTA does not seem to have too much to do with this since the chief block to

Japanese use of Canada as a production base for the giant U.S. market is the implicit threat of an agreement-busting local content requirement imposed by a runaway U.S. Congress.

It is curious that there has been sporadic talk of a North American policy or a European automotive trade policy, but very little attention has been given to a multilateral approach to the current automotive problem, which concept might be increasingly appealing if one thinks the unthinkable, that the world may have to live with restrictions on auto trade for a long time to come. Certainly the current North American automotive trade problem not only involves the U.S., Canada, and Japan but also has elements of trade deflection from Europe. The similarity of conditions in the automotive case to those which led other industries to multilateral agreements is striking. These include:

- significant production cost differences between countries;
- major markets are also traditional (high-cost) producers;
- growing investment mobility;
- excess capacity; and
- the problem of symmetrical treatment of product flows by stage of manufacture.

In such a situation there may be interest in some of the concepts incorporated in multilateral product trade agreements such as:

- recognition of the 'rights' of existing producing countries;
- growth provisions for new countries;
- phase-out provisions; and
- establishment of the industry agreement under GATT thus reinforcing that body as in the case of the Civil Aircraft Code.

Both the U.S. and Canada are grappling with these problems as are other countries as well. In an era that threatens to become one of bilateral managed trade in many industries, there might be some advantages to not ruling out a multilateral approach. While the Multifiber Agreement and putative international agreements on agricultural products are dirty words to those who value trade, they may not be as bad as what might otherwise develop through unilateral and bilateral actions.

NOTE

1 These comments reflect the author's personal views and do not represent the positions of General Motors Corporation or GM of Canada.

Comments

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The auto industry is Ontario's most important manufacturing sector. Some 85 per cent of Canadian car output, 97 per cent of truck assembly and 95 per cent of the manufacture of auto parts and accessories in Canada originate in Ontario. Not surprisingly, Ontario attaches high priority to the health of the Canadian automotive industry.

The industry is tied to the U.S. industry in terms of both ownership and trade and as a result of the Auto Pact has evolved along North America lines. Approximately three-quarters of Canada's assembled motor vehicles, as well as parts and accessories, are exported to the U.S.

Given the enormous Ontario interest in this sector, Ontario had been concerned with the failure of federal policy to deal effectively with massive and disruptive auto imports into Canada. Of critical concern is the issue of trade diversion. The federal government has addressed the threat of diversion into Canada that could have resulted from U.S. automotive restraint agreements with Japan by negotiating a roughly parallel set of restraints. However Canadian policy has not been prepared to come to grips with the reality of the much more significant diversion problem – namely the diversion of auto exports to North America which has resulted from particularly effective European import restraints against Japanese autos.

As such, options afforded under the GATT system itself have been left untested by the Canadian government. The possibility of initiating safeguard actions under Article XIX which could address the problems of disruptive Japanese auto imports has remained untried. Equally no serious consideration seems to have been given to the possibility of initiating an Article I action on the basis that nondiscrimination under the rules of the GATT apply to exports as well as imports and as such the special restraint arrangements which have been made by Japan (especially with individual European countries) violate the MFN concept.

Another particular concern Ontario has is the need to ensure Canada obtains a fair share of North American production. The Auto Pact provides a mechanism to achieve a Canadian share of North American auto output produced by the U.S. owned firms but there is no similar mechanism to ensure Canadian benefits from auto investments in the U.S. by non-U.S. firms especially Japanese firms.

Ontario is a significant consumer of Japanese cars. This has helped buoy Japanese export success in this sector. Ontario imported at least $1 billion (Can.) worth of Japanese exports in 1982. Canada itself is the fifth largest market for Japanese motor vehicle exports. In a recent trip to Japan, Ontario's Industry and Trade Minister Frank Miller made it clear that Japan must begin to think and act like the major world economic power that it is:

> [Japan] must now provide the benefits of job-creating investment in these countries which have supported its export expansion and hence its economic growth .... Ontario has traditionally been a strong market for Japanese products and nowhere is there a stronger case – or a better time – for Japanese companies to make investments in Ontario.[1]

It is with these kinds of concerns in mind that Ontario has felt that a strong position is appropriate vis-à-vis the Japanese. The Ontario Government has been on record favouring measures to raise the level of Canadian content in imported vehicles, and in a letter to Prime Minister Trudeau on July 15, 1983, the Premier of Ontario, William Davis, reaffirmed the Ontario government's support for measures to increase Canadian content in foreign vehicles sold in Canada. When taking this position, the Ontario government has generally linked the content provision to the necessity on the part of Canadian firms to raise their own productivity and competitive performance. This requirement is even stronger today given the radical changes taking place in the world automotive industry and the growing strength of off-shore suppliers. Mr. Miller's recent Estimates Statement in fact indicated that

> we are looking at the possible need for industrial restructuring on a larger scale, perhaps using government funds to anchor significant new private investments in crucial sectors such as the automotive industry.[2]

NOTES

1 Address by Honourable Frank S. Miller to the Canadian Chamber of Commerce in Tokyo, Japan, October 17, 1983.

2 *Estimates Statement* December 1983.

Canada/U.S. transportation issues

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INTRODUCTION

This paper will describe several transportation issues of current importance to Canada/U.S. trade. Most issues involve regulations on one side of the border that are different from those on the other. With the markets for transportation services in the two countries overlapping in so many areas, the country with the stricter regulation is under some pressure to conform with the other. Since, with several exceptions, it is the United States that has taken the lead in altering the regulatory climate, the pressure to conform has fallen primarily on the Canadians. Canadians feel an understandable annoyance at being pressured to make their policies conform to those in the U.S. when they had no say in the U.S. regulatory reforms. Nonetheless, with the transport markets linked as closely as they are, it is economic forces rather than diplomatic manœuvering that is exerting pressure on the Canadians.

Regulatory reform in the United States and in Canada

Until 15 years ago, the regulation of the transport sectors in Canada and in the United States was remarkably similar: the tools and outcomes were very much the same. As a general rule, regulation controlled prices, entry, and the technical rules of traffic interchange. It is now recognized that this system created various inefficiencies; but the arrangement did have the virtue of making cross-border shipment little different from domestic transportation in either country. Due to similar forms of regulation, transborder traffic moved quite smoothly, to the benefit of both economies.

The economic inefficiencies and financial losses created by the static system of regulation forced revisions of policies in both countries. The changes began with the Canadian railroads in 1967, but continued and accelerated in the late '70s and early '80s with some remarkable developments in the United States. Today, for virtually all transport modes, the regulatory environments in the two countries are quite distinct. This condition has combined with technological change in the deep draft shipping industry to create a series of new and unusual frictions in freight and passenger transportation between the two nations.

In retrospect, what is remarkable is not that Canadian and American transportation regulations have moved in different directions over the last fifteen years, but that they had ever been so similar. The difference in attitude toward government intervention in the two nations is well known:

> In English Canada, a radical spirit of laissez-faire or fear of government which might have been assumed to characterize most of those engaged in commerce and industry rarely seems to have taken hold.
>
> In contrast, the United States' political culture emphasizes individualism, the institutionalized dispersion of power – including that held by governments – pluralism, and participation in public life. (Stanbury and Thompson 1982a)

Even conservatives in Canada distance themselves from those in the United States, emphasizing that they stand for freedom as well as responsibility:

> Compared to Americans, Canadians have more frequently looked to their governments to take a strong role in economic development through the use of subsidies, taxes, and the direct provision of goods and services, to maintain a sense of cultural or national identity in the face of fundamental economic forces that contradict such desires, to restrict market forces (domestic and international) so as to provide a less risky environment for Canadian firms and individuals, and to achieve consensus and coordination of contending private or public sector efforts in order to avoid 'waste and duplication' ...

> There does not exist in Canada any fundamental belief in the virtues of competition as a method of allocating scarce resources ... our more structured, authoritarian society takes business power for granted. (Ibid., 708-9)

The American movement towards deregulation of transportation while the Canadians retained much of the institution is consistent with the historical inclinations of the two nations. Antitrust and regulation are not substitutes for Canadians since market forces are not an acceptable replacement for government supervision.

But in another way, regulation and antitrust have never been perfect substitutes. Market failure is only one rationale for regulation, the other being the provision of goods and services that the market would not offer, or with a price structure that a market would not allow. The main reason to choose deregulation – and this is the same justification for user fees for the provision of transport infrastructure – is to increase economic efficiency. In the case of both regulation and the provision of transport at prices that are not directly related to the cost of the service, a primary rationale has been the use of transportation to achieve goals other than maximizing the value of the goods and services produced in the economy.

That transportation should be used to achieve such non-economic goals as regional development, national integration, or a more equitable distribution of income has long been one of the arguments for regulation and against user fees. It was thus striking that part of the National Transportation Act of 1967, which gave Canadian railroads a large degree of commercial freedom, stated 'It is hereby declared that an economic, efficient, and adequate transportation system, making the best use of all available modes of transportation at the lowest total cost is essential to protect the interests of the users of transportation and to maintain the economic well-being and growth of Canada' (McManus 1977, 209). Yet in the implementation of the policy, the Canadian Transport Commission has been willing to consider other parts of the Act which deal with the far vaguer and more traditional non-economic goals of 'the public interest', 'undue obstacles', 'unfair disadvantages', 'and unreasonable discouragements'. At least one Canadian scholar believes that the result is that, 'Ten years after the National Transportation Act, it seems we don't know if we have a new transportation Act, it seems we don't know if we have a new transportation policy based on minimizing cost or the old one based on an 'equitable' regional distribution of economic activity' (ibid.). It appears that the changes have been quite uneven across modes, with some being effectively deregulated and others (notably aviation and trucking), almost untouched by the deregulation movement.

By contrast, the cumulative effect of the series of transportation bills and regulatory agency actions over the last six or seven years show clearly that the United States has made a decisive movement toward efficiency as the sole legitimate goal of transport policy. This paper will describe how this change in U.S. policy, in the absence of a parallel shift in Canadian law, has led to a variety of difficulties for transporters and for the passengers and shippers that they serve.

Since the focus of this paper is on the role of differential regulation in creating transportation problems between the two countries, the regulations covering each mode will be presented along with the issues that they have created. The paper starts with the Motor Carrier industry and then moves on to the Airline and Railroad sectors. The maritime transportation issues are described in the final sections before the conclusion.

MOTOR CARRIER ISSUES

The clearest example of regulatory-induced problems in Canadian-American transportation is seen in the highway freight industry. The complaints are heard primarily in the United States, and particularly from American trucking interests. They are the biggest losers under the current imbalance of regulatory regimes. The issue concerns more than just the trucking industries of the two nations, however. Smooth-flowing trucking traffic across the Canada/U.S. border is important to continued integration of the manufacturing economies of both the nations.

The movement of goods between Canada and the U.S. has, of course, never been as routine as domestic shipments across state or provincial borders. The impediments to transborder truck traffic consist of far more than different regulations covering the industry. Problems that transborder trucking has long faced include:

– a highway system in both countries that is oriented east-west rather than north-south.

- a lack of uniformity of vehicle size and weight regulations.
- an absence of highway tax reciprocity (a problem that will be exacerbated by the new highway equipment taxes contained in the Surface Transportation Assistance Act of 1982)
- normal tariff and customs regulations and procedures.[1]

With the passage of the Motor Carrier Act of 1980, which confirmed the substantial reduction in the regulation of motor carriers practiced by the ICC, another item was added to the list – a divergence of regulatory philosophy and practice in the two countries.

Canadian and U.S. trucking regulation compared

Trucking regulation in the U.S. and Canada appeared on paper to be remarkably similar until 1980. In both countries, authority to control routes, entry, and rates was given to the Federal governments. In fact, however, the enabling legislation necessary under the Canadian National Transportation Act was never passed and thus control of all aspects of for-hire trucking has remained at the provincial level (Janisch 1978, 34-6). The provinces have chosen to regulate both inter- as well as intra-provincial trucking in a variety of different ways.[2] Table 1 summarizes some of the main characteristics of Canadian provincial trucking regulation.

All inter-provincial motor carriage has reasonably strict entry restrictions, but lax rate regulations. The intra-provincial trucking markets of Ontario, New Brunswick, Nova Scotia, and Prince Edward Island and to a lesser degree Quebec, British Columbia and Newfoundland can be similarly described. At the opposite extreme is Alberta which long has had the freest entry into motor carriage of any area in North America (Chow, 1983). The strict regulators among Canada's provinces have followed the American lead in requiring certificates of convenience and necessity for every route that a trucker wishes to serve. In both the United States and in Canada this practice of route certification led to (among other practices) considerable interlining of traffic among companies that have complementary operating authorities. In the case of transborder carriage, such interlining of traffic has traditionally taken place at the border or at terminals in so-called gateway cities like Buffalo.

TABLE 1

Regulation of Canadian trucking

	Intra-provincial				Inter-provincial			
	Entry	Rate filing	Rate filing and approval	Rate prescription	Entry	Rate filing	Rate filing and approval	Rate prescription
British Columbia	Yes	n/a	Yes	No	Yes	No	No	No
Alberta	No	No	No	No	Yes	No	No	No
Saskatchewan	Yes	n/a	n/a	Yes	Yes	No	No	No
Manitoba	Yes	n/a	n/a	Yes	Yes	No	No	No
Ontario	Yes	Yes	No	No	Yes	Yes	No	No
Quebec	Yes	n/a	Yes	No	Yes	n/a	Yes	No
New Brunswick	Yes	Yes	No	No	Yes	Yes	No	No
Nova Scotia	Yes	Yes	No	No	Yes	Yes	No	No
Prince Edward Island	Yes	Yes	No	No	Yes	Yes	No	No
Newfoundland	Yes	na	Yes	No	Yes	n/a	Yes	No

SOURCE: Chow 1983, p. 46.

International interlining of traffic

Some interlining of traffic would be expected even in the absence of route certification. By allowing carriers to serve only a few industries or regions interlining can be a means of achieving economies of specialization. Nonetheless as a general rule truckers would rather not interline traffic, but do so because they lack operating authority for the complete movement. Interlining is more expensive than single-line service due to interchange handling. In addition, single line carriers are considered to have more desirable service to shippers as well – faster speeds, lower transit time variability, better loss and damage experience, and easier tracing of shipments (Chow 1983, 6).

Nonetheless a great deal more of Canada/U.S. transborder traffic has (at least before 1980) been interlined than has been the experience south of the border – more than 50 per cent of international shipments compared to about 10 per cent of all U.S. trucking (ibid.). Since U.S. trucking deregulation 1980, Canadian carriers have been rushing to expand their service in the United States to avoid interlining traffic with U.S. carriers.

U.S. carriers have difficulty getting certificates to operate in Canada

Canadian provincial authorities have not been nearly as eager to grant certificates of convenience and necessity to American carriers. The American Trucking Associations recently complained to the Ontario Transportation Board that the ICC has granted more than 400 new operating rights for Canadian owned or domiciled motor carriers since the beginning of the year as opposed to receipt of authority by 'less than a handful' of U.S. based lines from any Canadian province in the same period (*Traffic World*, 11 July 1983, 5).

Moreover, U.S. carriers have had difficulty expanding into Canada not only because of the regulations of the Foreign Investment Review Agency (Chow 1983). When operating rights are granted to a U.S. carrier, they are invariably restricted to international movements of commodities, while there are no such restrictions on Canadian carriers operating in the United States. Since there are complementarities between operating domestic and international networks, this practice has apparently worked to the advantage of Canadian carriers.

It is too early to have firm figures on the extent of diversion of transborder traffic from U.S. to Canadian carriers. In the past, there has been an approximate balance in the participation of carriers of the two countries – with either Canadian or U.S. carriers having an overall advantage depending on the measures used (tons, ton-miles, truckloads or revenues) and the types of traffic examined (less-than-truckload vs. truckload, exports to Canada vs. Canadian exports to the U.S.) (Chow 1982).

U.S. truckers try to induce changes in Canadian law

U.S. carriers have been loud in their protests over their disadvantaged position since 1980 and have requested their representatives to pressure Canadian authorities to reduce what they see to be inequities in their position relative to that of their Canadian competitors. The best publicized result was a short-lived moratorium on the grantings of operating rights to Canadian carriers passed by Congress in December 1982. The moratorium was an embarrassment to the U.S. administration which hastily consulted with Canadian authorities to determine what avenues of action were open to each side. The result was the publication of a letter of understanding between U.S. Trade Representative Brock and Canadian Ambassador Gotlieb in which each country promised negotiation instead of unilateral action to solve trucking disputes.

The five-point letter of understanding stated that the two governments recognized differences in policies and economies of the two countries, and promised consultation to encourage a competitive and efficient motor carrier industry, including more encouragement of single-line service. Both governments recognized, however, that the best that the Canadian federal government could be expected to do was to point out the problem to the provincial governments in the hope that they would free entry into their own motor carrier industries.

Most of the promised pressure has fallen on Ontario. This is not surprising in view of the fact that Ontario had both the most restrictive entry rules in Canadian trucking as well as the largest number of carriers engaging in cross-border haulage. The government of Ontario has responded by commissioning several studies.[3] In addition, several private groups have published reports and comments in an attempt to influence entry policy in the motor carrier industry.[4]

Following the pattern which was seen in the United States until the late 1970s, the Ontario motor carrier industry and regulatory authorities are far less willing than others to introduce radical changes in regulatory statutes. These parties have cast the issue as one of national sovereignty. For example, James Snow, Minister of Transportation and Communications of the Province of Ontario, stated recently that, 'We never pushed American trucking officials for a loosening of operating authority allowing us freer movement through the U.S.... The regulatory changes brought about by the Motor Carrier Act were not designed to enhance trade between the U.S. and Canada.' Snow is further quoted as arguing that 'Simply because the U.S. has changed its transport rules is no reason for Canada to enact similar reforms' (*Traffic World*, 11 July 1981). Snow's statement was well received by the Ontario Trucker's association whose own study indicated that as many as 5,000 Ontario jobs could be lost if American carriers were allowed free entry into Ontario.

John Kennedy, head of Kingsway group, a large Canadian trucking company that has just expanded into the U.S., says that with the big U.S. truck lines poised to enter Canada, there will be no market left for 'Ma & Pa Kettle' international operators interlining traffic at Buffalo. He predicts cross-subsidization of international routes by the large American carriers when they get into Canada. As an example, the Canadian Trucker noted that when St. Johnsbury, an American firm, got operating rights in Canada, it promptly cut rates 30 per cent (French, 25 July 1983).

Freeing of entry by American carriers into Canadian trucking inevitable

Nonetheless, there is a remarkable consensus that within the next two years, Ontario will find itself changing its trucking rules to make entry freer. The same trucker that deplored what he sees as the effects of free entry sees deregulation as inevitable. In addition to the diplomatic pressure that U.S. carriers have been able to exert on Ontario, Canadian manufacturers, fearful of losing their markets in the United States and hoping to lower intra-provincial rates as well, have called upon the Ontario Transport Ministry to drop all tests of public convenience and necessity in motor carrier licensing and replace them solely with a fitness test (*Traffic World*, 11 July 1983).

Phased elimination of 'convenience and necessity' showings for truck licenses is the key recommendation of the Ontario Public Commercial Vehicles Act Review Committee, in its report issued in June, 1983. It appears at this writing, that Ontario will pass such legislation, and that Manitoba and Quebec, which also have committees reviewing motor carrier legislation, will follow. U.S. motor carrier interests have been relatively quiet recently on the expectation that significant changes will soon be passed (Chow 1983).

Economic issues in the regulation of cross-border trucking

There are several economic consequences of different trucking regulations in Canada and the United States: first, is the health of the two economies. If it is conceded that further integration of the Canadian economy with that of the U.S. is desirable, then it is in the interests of both economies that trucking of goods between the two countries be performed as efficiently as possible and that no unusual impediments on trucking be placed at the border. The regulations that have encouraged interlining at the border clearly lead to inefficiencies, and the rise of a single-line cross-border trucking industry is economically desirable.

But deregulation of entry on only one side of the border is all that is necessary to provide cross-border shippers with single line service, and that is what we have today without any action necessary by Canadian regulatory authorities. What the current situation does lead to is a distortion in the production of a traded good – international trucking services. For no economic reason, Ontario truckers are able to bid for traffic that American carriers are disadvantaged at offering.

This is the second economic consequence of the differential regulations: a distortion in the comparative advantage of the production of trucking services. Such a distortion could be justified on grounds of either market failure or the use of regulation to promote non-economic policy. But there appears to be no market failure in the transborder trucking industry. There appear to be no scale economies or unusual government subsidies available to one country's carriers but not the other. There is every reason to expect that a normally working market for transborder traffic in which both country's carriers competed would lead to an efficient allocation of traffic.[5]

If there are non-economic goals served by Canadian trucking regulation, they are not well articulated: equalizing the advantages of different Provinces cannot logically be a goal since the regulation is not at the Federal level. The American experience demonstrates that an unregulated industry does not have difficulties with discrimination or undue preference to particular shippers or localities. It is hard to provide any credible explanation for the continuation of Canadian entry restrictions other than classic protection.

Ironically it may not be the Canadian carriers who are using the laws for protection – Minister Snow reports that it is primarily U.S. carriers who already operate in Ontario that are responsible for the protests against providing operating rights to new U.S. carriers (*Traffic World*, 11 July 1981). The annoyance of Canadian regulators at being expected to follow the U.S. lead in the regulation of trucking is understandable, but there are economically sensible reasons for them to do just that.

AVIATION ISSUES

While the source of the unhappiness is the same in the airline industry as in trucking – regulation altered in the U.S. and unaltered in Canada – the parties who are hurt are on opposite sides of the borders. In this case is the unregulated U.S. industry that has benefited, while the Canadian carriers have lost business to the U.S. The main reason for this outcome lies in the different motivations and practices of airline and trucking regulation.

Canadian policy towards airlines has always been suspicious of market forces.[6] From the 1940s through the 1960s, Canadian airlines were more strictly controlled than those south of the border – not only were entry and fares controlled, but unlike the U.S., route and service restrictions were placed on licenses. The announced reason for this policy was to improve transport opportunities to otherwise disadvantages localities, especially those in the North. Transcontinental service was made the monopoly franchise of Air Canada, a crown corporation. In order to ensure the expansion of regular service to all localities, charter operations were very carefully controlled. Through the 1970s, these regulations were very slowly liberalized, as CP air was allowed to enter the transcontinental market, the familiar form of advanced booking charters were permitted for non-business passengers, regional airlines were permitted some expansion of routes, and some discount air fares were permitted to the two transcontinental carriers.

Two reports on the reform of airline regulation appeared in 1981 at much the same time. The first, by the Economic Council, recommended:

- new entry into the long-distance airline industry based on a 'one-way swinging gate' which would temporarily shield the regional airlines from entry by the national carriers
- free entry into transborder operations, consistent with approval of the other country involved
- removal of all restrictions on service and all inter-airline understandings
- free abandonment of routes and almost free setting of fares
- great liberalization of charter service regulations
- restrictions on airline mergers
- an even-handed attitude toward government and non-government airlines (Stanbury and Thompson 1982b)

The other report of 1981 was prepared by the Minister of Transport who noted that

- the performance of the industry in Canada has been generally satisfactory
- deregulation in the U.S. can not yet be given a fair evaluation, and has probably harmed the financial condition of airlines
- there is no evidence that U.S. deregulation lowered air fares
- the stability of the Canadian airline industry is an important goal and one that cannot be pursued through deregulation.

For these reasons, the Minister of Transport recommended steps to assure the financial health of airlines and to guarantee the stability of airline service.[7] The opinion that prevailed in the end was the one held by the Minister of Transportation. Thus in aviation policy, Canada has consciously continued to use pricing and entry restrictions to serve non-market goals.

The contrast with U.S. policies could hardly be greater.[8] Over the last seven years or so, the United States has engaged in thorough reduction in government oversight over the passenger airline industry. In keeping with a market-oriented approach to the provision of air services, the CAB has recently extended this policy to air freight (*Traffic World*, 7 February 1983, 46-8). Behind these policies was a decision to abandon non-market criteria and to replace them with economic efficiency as the single goal of aviation policy.

Airline relations determined by economics and treaties

By an accident of geography, neither country has the ability to choose an airline policy without taking that of the other into account. With some American air fares now drastically lower than comparable fares in Canada, the passengers that Canadian policy has been depending upon to generate the revenue to pursue other goals have been streaming across the border to the United States and paying the lower U.S. fares. While unambiguous figures on the extent of the diversion are not yet available, some impressionistic evidence suggests that the change in travel patterns has not been minor, particularly for Canadians who have easy access to such American airports as Buffalo, Syracuse, and Burlington, Vermont. Canadians appear to be taking short hops across the border, either driving or taking a regional carrier and then continuing on a U.S. domestic or international ticket with a lower fare.[9] Canadian regulators and the regulated industry appear to be powerless to stop the practice of crossing the border to avoid the Canadian regulated price structure.

The fact that Canadian and U.S. air markets clearly have at least some overlap is contrary to the standard conventions of international aviation. Under standard procedures, two countries will negotiate landing rights for carriers of each country. Under a well-behaved system, the international traffic that a nation's airlines carry is determined primarily by the negotiating skill of the diplomats discussing air treaties.

There are such treaties between Canada and the United States just as there are between any two sovereign nations. International service between the United States and Canada is governed by three treaties: Scheduled Services (from 1966, amended in 1974), Preclearance (1974) and Charter (1974). As in all treaty negotiations, the question of equity is placed in a central position: equitable opportunity for airlines of both countries and equitable exchange of economic benefits. But equity is a difficult criterion for making economic decisions, especially when those decisions must be confirmed in the market place.

For example, to facilitate travel between two countries, the standard procedure is to engage in bilateral negotiations to increase the number of routes between two countries. But how does one decide on equity grounds which country's airlines should fly the new routes? In the case of the U.S. and Canada, Canadian travelers represent a substantial majority of those traveling between the two countries. But considerably more routes between the two countries are flown by U.S. than by Canadian airlines. Moreover, the Canadians point out that the identification of routes makes the imbalance appear even worse: for example, Toronto-Atlanta, a lucrative route, is flown only by U.S. carriers. But a substantial proportion of traffic is Canadian vacation travel to the U.S. South, and on this traffic Canadian charters have a virtual monopoly.

Canadians believe that a one-for-one parcelling out of new routes to the airlines of the two countries is unfair, given the imbalance that they perceive existing already. Even more serious from the Canadian perspective is that U.S. airlines will add Canadian spokes to existing hub-and-spoke systems, making each route added from Canada considerably more than just one new route. In addition, since hub-and-spoke systems have better frequencies than non-stop links, Canadian airlines believe that they must be granted a larger number of long-haul non-stop routes to compensate for the inevitably lower frequency of service that they can offer absent a similar hub-and-spoke system for Canadian airlines.[10]

The Canadian attitude that air relations between the U.S. and Canada should be a diplomatic rather than economic matter is illustrated in the recent Continental Case. A U.S. airline which did not have authority to fly to Canada requested permission from the Canadian government to quote a through fare from Canada to Australia via Los Angeles, making use of a Canadian connecting carrier. When the Canadian authorities refused to officially sanction this divergence of international traffic to U.S. airports – a movement that is currently underway, treaty or no – the CAB applied undiplomatically strong pressure on the Canadians in the form of a cancellation on short notice of discounts for Air Canada passengers flying to the United States (*New York Times* 1983).

Can Canada maintain a regulated airline industry?

The hub-and-spoke service, which U.S. airlines have been able to develop due to the nature of American geography is inherently more efficient than a series of long-distance non-stop services. If entry into the transborder market were free and passengers allowed to reach their destination in the least costly way, many Canadians could receive better and cheaper service by making greater use of the U.S. networks. This might, of course have the effect that Canada loses control of its international air connections as a more efficient American industry provides services at a price that Canadian carriers can not match.

But Canadian airline regulation is not based on the pursuit of efficiency, but on concepts of equity among customers and stability of the industry. Certainly the Canadian attitude is consistent with international aviation policies in most parts of the world. In international aviation the advantages of specialization are less obvious than in other parts of international trade. Thus, countries have been willing to subsidize and protect national airlines even when it would be efficient to have other countries perform air transport services (Gertler 1982).

The policies may prove more and more expensive to maintain in an area where a competing unregulated industry exists in the same market. It is still too early to tell whether a sufficiently large overlap between the Canadian and U.S. markets exists to permit a pricing and entry policy north of the border that is different from that in the deregulated airline market. If U.S. airline fares attract a large enough number of Canadians across the border, the question of whether Canadian airlines are granted a large number of route authorizations to Texas may become irrelevant. The important question may be whether Canada is willing to bear the expense of an inefficient Canadian flag aviation system, or whether the nation will, as it does for deep draft maritime services, depend on foreigners to provide its airline service.

RAILROAD ISSUES

Competition from airlines, the St. Lawrence Seaway, and the TransCanada highway forced governmental changes in the way Canadian railroads were regulated more than a decade before U.S. railroads were granted relief in the Staggers Act of 1980. In many ways the relief granted to the railroads in the two countries took much the same form: (1) reducing the ability of shippers to protest rates on the grounds of discrimination, equity, or reasonableness, and (2) encouraging the use of long-term contracts between shipper and carrier as a way of preventing either side from taking advantage of short run vulnerabilities of the other.

Both the U.S. Staggers Act and the Canadian National Transportation Act, gave railroads a great deal more commercial freedom than they had enjoyed before. The stated goal was to rely on competitive forces to improve the efficiency of the provision of freight transportation. A closer inspection of the two laws reveals that the forces counted on to achieve efficient freight transportation in two bills were not identical. In Canada, it was intermodal competition that is to restrain railroad ratemaking. In the United States, the Staggers Act was premised on the desirability of both inter- and intra-modal competition. For that reason, the American rules forbade the use of rate bureaus to discuss any rates other than end-to-end joint movements, and invoked the penalties of the Sherman Act against parties that continue the century-old practice of discussing rates with competitors. By contrast, Canadian law requires that the Canadian National and Canadian Pacific Railroads discuss rates with one another in an attempt to prevent ruinous competition between them.

Perhaps nowhere else in the transportation policies of the two countries is the U.S. distrust and Canadian acceptance of monopolies as clear as in these provisions of the two laws governing railroads. While apparently similar in most provisions, the two laws are philosophically opposed – the Americans requiring competition between their railroads, and the Canadians forbidding it, preferring instead to rely on the responsible behaviour of large organizations.

But political philosophies alone do not explain the differences between U.S. and Canadian regulations. The differences also reflect the operating environments of the two railroad systems.[11] In Canada, the railroad industry is organized effectively as a duopoly – two systems that interchange very little traffic between each other. With one of the participants a Crown corporation and the recipient of various capital assistance, it would appear unrealistic to count on the benefits of intra-modal competition.

The structure of the U.S. industry is in the process of rapid change. Under the provisions of the old Interstate Commerce Act, a large number of regional systems interchanged traffic under the supervision of the ICC. In the last two decades, mergers have reduced the number of railroads and extended their lengths. The reduction of ICC rules on traffic interchange is similarly encouraging railroad systems to keep traffic on their own tracks wherever possible. The structure of the American industry is beginning to resemble that of the Canadians. Nonetheless, it is unlikely that the American railroad map will ever contain as few major carriers as the Canadian. Intramodal competition appears more feasible in the United States, as well as more in keeping with economic philosophy.

Canadian grievances

The major complaint currently voiced by Canadian railroads is the contradictory requirements placed on them by Canadian and U.S. railroad regulations. Under the National Transportation Act, the CN and CP are required to consult jointly before signing a contract with a shipper for services, and the terms of the contract must be made public. The contracts can technically be protested as being discriminatory, but none has ever been (Heaver and Nelson 1977, 80). With one major exception – that of grain rates – the Canadian system can be described as compulsory collective ratemaking with a non-confidentiality restriction, but otherwise unhampered by government supervision.[12] The American system introduced under the Staggers Act is one which forbids collective ratemaking and permits secrecy of the contract provisions. Both systems can be called deregulation, however, because they limit the ability of the government to affect the pricing of services.

American railroads have been quick to take advantage of the new freedom to negotiate secret contracts. Agreements covering cross-border movements, however, put Canadian railroads in the uncomfortable position of being required to discuss rates with their competitor in Canada but nonetheless being able to show to a United States court that they have not violated the Sherman Act by discussing prices for services purchased by American citizens. Since the laws are logically contradictory, the railroads find that they must violate the laws of one country or another. (This extraterritorial reach of the U.S. antitrust laws has been a constant source of friction between the U.S. and its trading partners in many areas, not just in railway policy.)

While the ICC has indicated a willingness to accommodate the wishes of the Canadian railroads, the Justice Department has been firm that no discussions of deregulated movements (COFC/TOFC, boxcar movements, and fresh fruits and vegetables) will be permitted. The CN and CP are afraid that they will be required to pay huge antitrust damages (see Lande 1983a). While the source of the difficulty is the extraterritorial application of the U.S. antitrust laws, it should be noted that this problem could be solved by the Canadians by providing a special exemption on consultation for cross-border shipments.

A second difference in regulation of railroads in the two countries has reduced the ability of Canadian railroads to engage in competitive ratemaking against U.S. carriers. Imagine that the CN or CP wished to encourage a shipper to use a routing most advantageous to it rather than a competing routing which used a U.S. carrier for a greater portion (or all) of a movement. The U.S. carrier could offer the shipper contract terms confidentially, while the Canadian carrier would have to inform the shipper that Canadian law might require that the terms of the contract be published for competitors and for other railroads to read.

The Canadian carriers believe that any shipper would be reluctant to sign a non-confidential contract when a secret agreement was available. Under these circumstances, Canadian railroads have followed the unsatisfactory procedure of letting their American partners in a joint movement take the lead in contract negotiations, under the understanding that the Canadian railroad would never know the true rate agreed upon, and that the contract might impose far higher loss-and-damage liability on the Canadian carrier than on the U.S. railroad. The result is sure to be either less traffic or lower rates than could be obtained if the carriers could negotiate equally against American railroads (Lande 1983b).

A final procedural matter which used to be smoothly handled under regulation is now a further source of friction between the railroads of the two countries. The Interstate Commerce Act used to set rules for interchange of freight cars among railroads. Deregulation has given U.S. railroads greater freedom to route boxcars (except those owned by Canadian railroads) to make the most efficient use of the fleet. Under U.S. Customs law, Canadian cars cannot be loaded in the United States unless the shipment if routed in a northerly direction. This puts Canadians at a disadvantage with respect to the return of equipment and empty mileage charges, raising their costs. The rules requiring special treatment of Canadian cars further removes the CP and CN from an integrated North American railroad system.

In summary, the Canadian railroads argue that the differential requirements on collective ratemaking have exposed them to antitrust liability; that differences in regulations concerning the confidentiality of contracts has hampered their ability to bid for preferred routings of transborder and overhead traffic, resulting in less traffic and smaller revenues on traffic that they manage to retain; and that the deregulation of equipment interchange has uneconomically burdened the exchange of traffic with U.S. carriers.

American concerns about Canadian railroad behaviour

Under these circumstances, it is small wonder that the Canadian railroads are aggressively trying to expand south into more U.S. markets. Canadian railroads, unlike their American counterparts, are already strong on the opposite side of the border. U.S. railroads with freight bound for Canada are required to interchange almost all international traffic with one of the Canadian railroads. The American subsidiaries of Canadian railroads – the Soo Line is the Canadian Pacific affiliate and the Duluth, Winnipeg and Pacific, Grand Trunk, and Central Vermont railroads are owned by the Canadian National – enable the Canadian routes to tap traffic as far south as Chicago, Cincinnati, and New London. Under merger plans currently under review, the reach of the Canadian lines would be extended to Kansas City.[13] This attempt to further expand penetration into U.S. railroad markets has been met with loud unhappiness in certain sectors of the U.S. economy (see, for example, Gross 1982).

The unease arises due to the long-standing railroad practice of long-hauling – that is, interchanging traffic with other carriers or modes in places that guarantee the longest practical haul for the originating carrier. This practice was encouraged by rate division policies followed by the Interstate Commerce Commission before the passing of the Staggers Act whereby railroads that interchanged traffic divided the through rate approximately on distance. Since railroads have very low marginal costs relative to average costs per ton-mile of operation, if a railroad managed to hold traffic longer, it could get a larger proportion of the revenue while costs are not greatly increased.

In the late 1970s this phenomenon led to such bizarre behaviour as routing landbridge traffic from London to Chicago via Winnipeg.[14]

Long-hauling can take the form of pricing to encourage a shipper to use a destination on the railroad line as opposed to an alternative which would require interchange. Great Lakes as well as East Coast port interests believe that the Canadian presence in the United States allows the Port of Montreal to bid for traffic to the disadvantage of both the Great Lakes as well as U.S. East Coast ports. The reason is seen in the geography of the Canadian rail systems which give Canadian carriers direct, long-haul routes to the Atlantic.[15] The fear is that the purchase of additional American lines by the CP and CN will cause even more traffic to move via Canada rather than Chicago or Baltimore (Armbruster 1981).

On the basis solely of theoretical reasoning, unregulated railroads should not engage in long-hauling. According to long-standing tenets of economic theory, firms that maximize profits will not vertically squeeze or foreclose markets to upstream competitors. Thus if railroads are free to negotiate rate divisions, originating carriers should interchange traffic optimally. It is clear from the first experiences with U.S. deregulation that the theory is invalid, at least as applied to unregulated railroads – they have been pushing to close interchange points with other carriers as rapidly as they can. In the East, the most important American railroad for Canadian traffic interchange has used deregulation to close all interchange points where it does not have a long haul (Lande 1983b).

The Canadian wish to maintain their sources of traffic by expanding further into the United States thus appears to be logical and legitimate. In fact, it is somewhat surprising that they have not been even more active in the merger movement. One of the unforeseen effects of the Staggers Act appears to be a squeeze on small railroads that must interchange traffic with other carriers. Those parts of the bankrupt properties that the Canadian railroads wish to purchase will thus inevitably become part of another system; if the traffic is not diverted to Montreal by a Canadian purchase, it could equally as well be diverted to New Orleans by an Illinois Central acquisition. The point is simply that traditional traffic patterns will change as the American railroad system is reduced to a few competing closed networks. With traffic patterns determined by the historical accident of trackage ownership, there is no economic rationale for preferring one owner over another.

It seems anachronistic to mourn for the old system of smooth interchange across the border or to deplore the effects that differential regulations have had. It is difficult to imagine any U.S. government policy that could be implemented that would allow Canadian lines to compete for American interchange traffic as aggressively as they have in the past when the institution of traffic interchange appears to be in the process of disappearing. If the Canadian carriers are to maintain their favoured position in the American market, they will have to become even more deeply involved in the American merger movement.

DEEP DRAFT SHIPPING ISSUES

The exception to the rule that Canada regulates its transportation more strictly than the United States is deep draft shipping. Perhaps because Canada has no deep-draft liner industry under its own flag which can ask to be protected by regulatory authorities, the regulation of overseas shipping lines is more lax in Canada than in the U.S. Nonetheless, the differential regulations appear once again to have caused problems for the country with the tighter controls.

Both the United States and Canada have imposed rate filing requirements on all liner cartels under their jurisdiction, and both countries specifically exempt rates discussed by such cartels from prosecution under the relevant antitrust statutes (Tetley 1982). The economic rationale for these policies are the familiar worries about ruinous competition, and chronic excess capacity, as well as the more novel claim that the cartel will provide a more efficient level of service by internalizing the externality implicit in the quality of service being determined by the aggregate frequency of all sailings.[16]

The contrast between the language of the Canadian statutes governing surface land transport and those covering the liner cartels is striking. In the former, the rationale for the regulations is couched in terms of equity, stability, and non-discrimination. By contrast in the statutes covering the liner trade, 'the main policy consideration is to provide Canadians (manufacturers, farmers, businessmen and consumers in general) with efficient inexpensive transportation of goods to and from Canada (Tetley 1982, 1-25).

U.S. and Canadian treatments of liner cartels differ in two major respects: (1) Under U.S. laws, all cartels must be open, while under Canadian law, closed cartels are permitted; and (2) Canada depends on rate filing, 'on the assumption that filing will inhibit nefarious activities', while the FMC in the United States requires prior approval of rate schedules as well as filing of rate.[17] Entry does not require government approval in either country, the level of service is not specified, and (in Canada), the level of rates is not under government authority. It is argued that 'There is no integrated scheme in Canada for regulating the non-coastal and non-internal shipping industry, nor is such a scheme intended ... there is no policy and no administrative body to regulate external shipping (Tetley 1982, I12).

While U.S. regulation is more lax than traditional surface transport rules, the U.S. still does regulate the deep draft industry. In requiring prior approval of cartel agreements, the United States differs from most nations. Under U.S. law, the Federal Maritime Commission must find each agreement to be not unjustly discriminatory, to the detriment of the commerce of the U.S., contrary to the public interest, or in violation of the terms of the Shipping Act. The right of a shipping line to act outside the cartel is, however, guaranteed (in both countries), and that right has been exercised.

The issue of traffic diversion

American Atlantic Ports complain that U.S. shippers have diverted cargoes through Canadian ports in order to take advantage of the more lax Canadian regulation of the ocean freight industry. The question of traffic diversion has already appeared in the previous section of this paper where it was noted that the choice of port for export cargoes is often influenced by the railroad map as well as by the service and costs of using particular ports.

The ability to switch cargoes between U.S. and Canadian ports derives from the same accidents of geography that have hampered Canadian regulation of airlines. Cargoes from the northern tier of the United States or from virtually any part of Canada which are found overseas can be shipped from either country's ports. The direct route for exports from the Great Lakes region of the United States to Europe is through the St. Lawrence valley and Canadian territory. (This situation is not unique in the world, being replicated in Europe where Holland controls the direct all-water route for West German exports to

North America.) One would expect, therefore, on the basis of geographical considerations alone, that some U.S. freight would be transshipped through Canada. On the other hand, the size of the American economy makes service at U.S. ports to destinations other than Europe better than from Montreal; for this reason if no other, one would expect some Canadian freight to be transshipped through U.S. ports.

Most public discussion of cargo diversion has concerned containerized container trade. Table 2 shows figures used by Canadian authorities to argue that containerized cargo travels both directions across the border for transshipment, and that the idea of an unbalanced diversion of cargo is thus illusory. The table shows that in 1982 there was an approximate balance of cargoes crossing in each direction (Canada 1983). There appear to be no contradictory figures in the U.S. to doubt the Canadian claim that there is such a rough balance in containers.[18] A closer inspection of Table 2 reveals, however, that the balance is achieved by combining together two quite unequal ratios. According to the table, about 500,000 Canadian containers traveled through each of the two U.S. coasts in 1982 while about 1,000,000 U.S. containers traveled through Canadian Atlantic ports. Virtually no American containers exit through Canadian West Coast ports.

There is, of course, no economic virtue in equal numbers of containers transshipped through transborder traffic unless the balance is achieved due to a search for efficient routes. Economic reasoning and experience does not suggest any reason why such a physical balance should be generated by economic forces. In fact it appears as if it is an accident, with unrelated forces together producing a not-necessarily-efficient equality of container movements. A partial explanation appears available in the difficult labour situations in the ports of Vancouver, B.C., which shifted freight on the West Coast (Tetley 1982), and in the Port of New York which has diverted East Coast freight to Canada.[19] It seems plausible in addition that many of the Canadian containers were attracted to American ports simply because U.S. ports have more frequent sailing schedules to places other than Europe.[20]

It is, however, undeniable that the long-term trend in transborder shipment of international traffic has favoured the Canadians, and that this diversion has accompanied a divergence of freight rates fa-

TABLE 2
Summary of transborder container movements in Canadian and U.S. overseas trade, 1982 (all figures in twenty-foot equivalent units)

	East Coast	West Coast	Total
Canadian trade via U.S. ports			
Canadian exports	27,539	13,415	40,954
Canadian imports	18,545	41,041	59,585
Total Canadian trade	46,084	54,456	100,539
U.S. trade via Canadian ports			
U.S. exports	45,481	854	46,335
U.S. imports	53,760	109	53,869
Total U.S. trade	99,241	963	100,204
Balance: Canadian containers less U.S. containers	53,157	−53,493	−335

SOURCE: Revenue Canada.

vouring Canadian over U.S. East Coast Ports. The diversion has also coincided with the offering of a new intermodal through billing service by carriers serving Canadian ports – in particular Cast North America, formerly a subsidiary of the Swiss-domiciled firm, Euro-Canadian Shipholdings.[21]

The new service was offered beginning in the early 1970s, and differed in a number of ways from traditional transportation of export and import cargoes:

- the service was intermodal, allowing a shipper to deal with a single firm rather than separately with a domestic carrier to a port and then with an overseas liner
- the domestic and international rates were rolled together in a single price
- the services were provided outside the traditional liner cartels.

Under the new system, containers are trucked or sent by railroad to Montreal for placement on container ships for Antwerp. This so-called Canadian landbridge has attracted 80 per cent of the container cargo from Michigan to Europe, and large quantities of traffic from other Great Lakes states.[22] Following the success of Cast in attracting cargoes, the service has been imitated by other carriers. An American carrier, Sea-Land Services, has recently started container service from Halifax to Europe in what may be yet one more rival for American export cargoes.[23]

Immediately before the introduction of the new Canadian service, such export traffic would have been funneled through U.S. East coast ports. These ports have complained bitterly about the loss of cargo. For example, Fred DiBona of the Philadelphia Port Authority is quoted as saying, 'The Congress cannot allow this sorry situation to continue and deprive American motor and rail carriers of these cargo movements, American workers of the right to handle this cargo, and the northeast port of millions of dollars of needed revenue to revitalize our own ports and infrastructures' (*Traffic World*, 22 June 1981, 7). The shipment of American containers through Canadian ports is not limited to those originating in the Mid-west, however. Complaints by U.S. North Atlantic Ports claim that Cast is the 'leading predator of New England cargo' as well (Salzano 1981).

Is regulation the reason for traffic diversion?

That U.S. East Coast ports have lost traffic to Canada is undeniable. The only question is why. Part of the answer is technological change. The introduction of containers has altered radically the economics of port operation. In particular, the tremendous increase in the size of container vessels has increased the economies of scale of port operations. Technology makes it inevitable that most ports will lose cargoes to the few that have the volume of shipments necessary to enable container lines to offer frequent service (Tetley 1982; vii-2).

Another reason for Cast's success apparently lies in the innovative use of inter-modal service, offering a shipper the opportunity to deal with a single transport service for all parts of the business.[24] Following Cast's lead, most U.S. members of liner cartels have now applied for authority to offer intermodal rates through the liner cartel (Armbruster 1983).

Technological change and innovative service offerings do not alone explain the success of the Canadian ports in attracting U.S. traffic. Cast has operated outside of liner cartels, and it is presumed that the rates that it is offering represent classic undercutting of cartel prices by non-member competitors. Moreover, as a non-member, Cast and similar lines are not subject to the tariff filing requirements imposed on both U.S. flag and foreign flag carriers for shipments loaded and discharged at U.S. ports (Tetley 1982). U.S. ports complain that Cast operates with an economically unjustified advantage of secrecy while the rest of the cartel must publish rates.

The cargo diversion bills

U.S. East Coast port authorities have responded to the loss of cargo to Canada by proposing that FMC regulation be extended to U.S. cargoes travelling through Canadian ports. There have been a variety of 'cargo diversion bills' proposed over the last several years, and some that are currently under consideration.[25] The provisions most favoured by U.S. port interests would require filing by Cast and other carriers of rates charged for shipment of U.S. cargos transiting through Canada.

This requirement appears innocuous at first. American proponents stress that, 'the change would not place carriers offering a service through the ports of our neighbours at any regulatory disadvantage, but rather it would place such carriers on an equal regulatory footing with competing common carriers by water' (*Traffic World*, 22 June 1981). Also, 'it is not new regulation, it is merely patching a large loophole in the present regulatory scheme' (Salzano 1981).

A closer inspection of the proposal shows that it is far more significant than it appears on the surface, since filing the rate with the FMC would give that body jurisdiction for finding the rate to be unjust or detrimental to United States trade. Confirmation that the concern of U.S. ports is not rate information but the ability to protest rates from Canada to Europe is found in the observation that a bill which would allow interested parties to inspect but not protest Canadian rates was found unacceptable to American interests (Auwers 1983).

Cargo diversion bills have been favoured by U.S. East Coast congressmen, but have been opposed by Midwestern representatives and shipper interests, as well as the Canadian government which considers the attempt to regulate rates at Canadian ports to be an infringement of its sovereignty. It appears that there is not currently enough support for the bills to pass.[26]

Another form of cargo diversion provision is found in a bill (S.865) currently in Congress under which ships using U.S. ports would be taxed to pay for port development. Recognizing that this might encourage greater use of Canadian ports, the bill states that

> It is unlawful for any person engaged in waterborne commerce knowingly to divert or cause to be diverted any deep-draft commercial vessel containing commercial cargo destined for use or consumption in the United States from a port within the United States to a port outside the United States for purposes of avoiding the tax imposed. Any person in violation shall be subject to penalty not to exceed double the amount of the tax which would otherwise be imposed.

The author of the bill does not suggest any means for determining which cargo has been diverted to avoid the tax, which to avoid regulation, and which to take advantage of superior service. The provision is in its current form is thus unenforceable. But this is the problem with all cargo diversion bills. There is no way of knowing to what extent differential regulation has caused diversion; and even then there is no economic justification for solving the problem by making regulations for cargo exiting through Canada the same as those in the United States rather than vice versa. Here is one situation where the overlap of U.S. and Canadian transportation markets makes it difficult for the United States to avoid following the Canadian lead in regulatory reform.

Coming changes in regulation of liner trade

Overshadowing all of the cargo diversion bills are two policy changes that will apparently come into effect during this calendar year; first, a comprehensive rewriting of U.S. regulations covering deep draft international trade; and second, a new international code for the liner trade which promises to drastically alter the role of shipping cartels.

The current administration has promised a bill to rewrite U.S. deep draft regulations. Several other bills are currently under consideration by Congress (*Traffic World*, 7 February 1983). At this point it is impossible to predict whether the new bills will increase or decrease regulation of the container trade (Armbruster 1983). In recognition of the fact that a bill which removed tariff filing requirements would eliminate the principle device in the cargo diversion bills, the latter have been tabled until the question of new shipping regulations is resolved.

More serious for all international cargo movements by water is the introduction of the UNCTAD Code of Conduct for Liner Conferences

(Tetley 1982). One apparent effect of the code would be to discourage the use of third countries for carrying cargo in bilateral trade. This should gradually reduce the influence of currently constituted liner cartels as third world nations increasingly carry their own imports and exports on ships with their own flag. The changes will particularly affect Canada which has no deep sea fleet at all. It remains to be seen how (or whether) the North American Governments will implement the UNCTAD agreement and what effect this will have on the current practice of shipping U.S. cargoes for export to Europe through Canada on ships which generally fly the flag of yet a fourth nation.

INLAND WATER TRANSPORTATION ISSUES

The major Canada/U.S. transportation issues surrounding inland water transportation relate to the Great Lakes and the St. Lawrence Seaway. The St. Lawrence Seaway is a joint operation of the United States and Canada, but far more of the operations and far more of the cargo is on the Canadian side. Canada operates 13 of the 15 locks between Montreal and Lake Erie, and 70 per cent of the traffic is Canadian. Virtually all of the Canadian merchant marine is engaged in carrying cargoes (primarily grain) from the Lakehead to lower St. Lawrence ports for transshipment, and carrying iron ore and coal upbound for U.S. and Canadian mills. Seaway cargoes have recently been confined to dry bulk commodities – in addition to grain, ore, and coal, there is a little salt, stone, petroleum, cement, coke, and gypsum. There is no package service left on the Lakes and no container ships will call this year (Gemmell 1983).

There is no regulation by either nation of rates or service on the St. Lawrence Seaway, except to the extent that domestic cargoes on either side must be carried in ships of that nation. It would appear that differences in regulation could not be the source of problems of transportation policy. But the problem of how to charge for use of the system is a close relative of the problem of optimal regulation. Currently, the Great Lakes connecting channels are used free of charge by ships of both nations. Seaway financing is unique in North America as the only waterway to charge tolls. Tolls are jointly set by agreement between the Authorities on both sides of the Lakes, with Canada receiving about 70 per cent of tolls on the Montreal-Lake

Ontario segment and 100 per cent of the revenue from the Lake Ontario-Lake Erie segment.

There is no difference in Canada between Great Lakes/Seaway policy and domestic inland waterway policy – there are no other navigable Canadian waterways. On the American side, the Seaway is a small fraction of domestic water commerce. U.S. inland waterway policy tends to be made with primary concern for shipments on the Mississippi River and tributaries – they comprising the largest segment of the industry. This has worked to the detriment of development interests on the U.S. side of the Great Lakes, since these groups compete directly with the Mississippi and New Orleans for export cargoes of dry bulk cargoes, particularly grain.

While the U.S. government currently provides navigation aids on the Mississippi free of charge, those who export through the Lakes are obliged to pay tolls. Changes in tolls and improvements in navigational aids on the Northern Coast requires international consultation. Groups favouring improvements in competing facilities in the United States interior need only talk to those in Washington. This necessity for international consultation (something to which U.S. policy makers are not generally accustomed) has brought about some impatience and annoyance on both sides of the border.

Illustrative of the American forgetfulness to consult before proceeding is the Corps of Engineers unilateral decision to study the effects of winter navigation on the Great Lakes and connecting channels, despite the opposition of Canadian interests,[27] and Corps studies of modernization and expansion of Seaway locks, despite vociferous complaints of Canadian environmentalists (*Seaway Review* 1982).

More serious from the Canadian government perspective, however, is the current series of bills in the U.S. Congress to move to a system of user charges for the general provision of maritime infrastructure. User fees are being proposed as a way of recouping the cost of maintenance as well as construction of port and waterway facilities throughout the United States. These bills include provisions relating to the Great Lakes and the Seaway. The proposals in two bills (S.970 and S.865) would place user fees on Lakes navigation and change the system for paying for the Seaway from a toll to a tonnage or *ad valorem* based user charge scheme.[28]

The unilateral attempt to charge for use of the Great Lakes (opposed by all navigation interests) and remove tolls from the Seaway (something long favoured by American Great Lakes interests) has been coldly received in Canada (*Globe and Mail* 1983). According to official Canadian policy, the concept of user fees for infrastructure provision is not in itself unacceptable, but the lack of consultation is irksome, and against treaty provisions. If the U.S. government wishes to change the means of financing of joint waterway, it should expect to negotiate the action (Canada 1983).

It appears that the negotiations will be difficult. User fees for infrastructure provision is opposed both to the traditional U.S. approach to transportation as well as current Canadian policy for other modes. While the likelihood that either bill will pass in current form is slim, a move to user charges for the American inland water system appears likely. How to coordinate those changes with Canada (or whether to leave the American Great Lakes as an orphan of transport policy) are questions that will have to be answered eventually.

CONCLUSION

This paper has demonstrated that differences in regulation lie at the base of many of the Canada/U.S. transportation issues. The preceding pages have described these problems for each mode of transportation.

- Motor carrier issues are primarily those of licensing. The U.S. has allowed free entry of Canadian motor carriers into domestic and transborder routes, improving the efficiency of movement by offering single-line service on links. International traffic interchanges had been necessary before. In what appears to be protectionism, the Canadian provinces, which have authority over motor carrier issues, have been reluctant to grant similar authority to U.S. carriers. Responding to a combination of pressure from the Canadian manufacturing community and the U.S. trucking industry, it appears that the provinces will soon allow freer entry into the Canadian trucking industry.

- The primary aviation issues involve the contradiction between standard international procedures for governing air relations – bilateral treaties where questions of equity play a central role – and the market reality that both Canada and the United States are in much the same airline market. The diversion of passengers to U.S. carriers as the Canadians have tried to maintain the regulated price and route structures has made it difficult for the Canadian authorities to continue to regulate their domestic market as they would wish and has changed the terms under which air treaties with the U.S. can be negotiated.

– The complaints of the Canadian railroads center on Canadian rules which contradict those which they must follow in international movements to the United States. The Canadians complain that they are placed at a cost and bargaining disadvantage by the Canadian laws, and risk exposure to U.S. antitrust violations. The result has been a weakened presence in the U.S. market – a change from their position during the last fifteen years or so. This paper argues that while the Canadian railroads' problems stem from U.S. deregulation, their problems can only be solved by lessening reliance on interchanging traffic with other U.S. carriers.

– The regulation of deep draft shipping is more lax in Canada than in the United States, and some U.S. port interests have urged extension of U.S. regulation to U.S. traffic transshipped through Canadian ports in an effort to prevent traffic diversion. This paper concludes that there is no economic justification for the port diversion bills. In any case, it appears that there will soon be major shifts in the rules governing all trade by deep draft vessel, and the U.S. port attempts to disadvantage their Canadian rivals will be overwhelmed by the changes that will soon affect all maritime interests.

– Inland waterway issues concern the Great Lakes and the St. Lawrence Seaway. It appears that the U.S. will wish to introduce a system of user fees on the common waterways that conform to taxes imposed on other facilities in the United States. Since under previous treaties, the waters are used free of charge (or in the case of the Seaway, under a jointly set toll) by both nations, the American attempts to impose user fees (that is, implicitly setting efficiency as the criterion for waterway development) will create problems similar to those that have been seen with other modes of transportation.

It appears that with the transportation market overlap between Canada and the U.S., deregulation in one country has limited the options available to the other to regulate its transportation industries as it would wish. Since Canada is, in general, the country with the stricter regulation, it is that country whose transportation options have been narrowed.

NOTES

1 This list is adapted from Chow (1982), 7.
2 A good description of the complexity of provincial trucking regulation can be found in Maister (1978).
3 A report on the likely consequences of freer entry into the trucking industry, written by the Ontario Highway Transport Board for the Minister of Transportation of Ontario, had not yet been released at the time this paper was written; a two year study by the Public Commercial Vehicles Act Review Committee was published by the Minister of Transportation under the title *Responsible Trucking* in June, 1983.
4 A private study by Blue Apple Consulting of Toronto for the Ontario Trucking Association and a statement by the Canadian Manufacturers' Association are described in Foster, Cecil, 'Trucker's report warns of dislocation under open border policy,' *Globe and Mail*, 25 July 1983, B7.
5 The primary form of subsidy provided by the U.S. (underpriced roadway) is equally available to Canadian carriers. Canadian carriers receive only minor subsidies not available to U.S. carriers (occasional loan guarantees, subsidies to carriers who engage in shipping with the Atlantic region, and financial connections of some firms with Crown corporations) Chow (1982).
6 Much of the descriptive material in this section is drawn from Stanbury and Thompson 1982b, 39-50.
7 Minister of Transport, 'New Domestic Air Carrier Policy', (Ottawa: DOT, Public Affairs, No. 148.81), 2; quoted in Stanbury and Thompson 1982.
8 For an excellent description of the process by which U.S. airline deregulation was effected, see Stanbury and Thompson 1982, 678-720; see also Reschenthaler, G.B., and Stanbury, W.T., 'Deregulating Canada's Airlines: Grounded by False Assumptions', *Canadian Public Policy*, 9(2)210-222, (1983).
9 Klymchuk, Andy, Office of Strategic Policy, Transport Canada, 593-5696, personal communication, 5 August 1983; see also, *Wall Street Journal*, 'U.S. Air Fares Pull Canadians Across Border,' 18 March 1983, 1.

10 Pelkola, D.W., Transportation and Communications Division, Department of External Affairs, Ottawa, Personal Communication, 4 August 1983.

11 An excellent summary of the rationale for collective ratemaking in Canada is found in Heaver, Trevor D., 'Competition and Collective Pricing Between Railways in Canada,' A study of the issues with and alternatives to railway pricing under Section 279 of the *Railway Act* and Section 32(2) of the *Transport Act*, prepared for Transport Canada, January 1983.

12 At the time this paper was written, the Canadian Parliament was discussing a series of measures to substitute subsidies for the current statutory grain rates known as Crows Nest rates. While there appears to be general agreement on the logic of higher remuneration to finance the addition of grain hauling capacity to serve Canada's expanding Pacific markets, there is no agreement on the form that the new subsidization scheme should take. The literature on the desirability and effects of the Crows Nest rates is huge. Some of the recent discussions include, Maister, D.H., 'Technical & Organizational Change in a Regulated Industry: The Case of Canadian Grain Transport', in Stanbury, W.T. ed., *Studies on Regulation in Canada*, (Toronto: Institute for Research on Public Policy, 1978); Chapman 1983, Stewart-Patterson 1983, B1; Foster, 13 June 1983, B9.; *Traffic World*, 7 February 1983, 77.

13 The Soo Line was recently denied entry to Kansas City when the Chicago and Northwestern's competing offer for trackage of the bankrupt Rock Island was accepted in place of the Soo's. The Chicago and Northwestern is similarly challenging the Grand Trunk's purchase of the Milwaukee Road. See *Traffic World*, 15 August 1983.; also *Traffic World*, 18 July 1983, 60; *Traffic World*, 7 February 1983, 76.

14 Klymchuk, Andy, Office of Strategic Policy, Transport Canada, personal communication, 5 August 1983.

15 Some support for this claim has been provided by recent hearings before the Canadian Transport Commission in which the CN admitted making secret payments to Cast steamships lines to compensate for lower rates offered by U.S. railways. *Globe and Mail*, 'CN could have lost business if Cast not paid, CTC hears,' 19 November 1983, B2.

16 Heaver, Trevor 1982. Heaver notes that the argument of chronic excess capacity of an unregulated industry appears to be contradictory to the claim that absent regulation, sailings would be less frequent than desirable.

17 Tetley 1982. There are provisions for suspending rates under Canadian Law, but they have never been used since no rate has ever been protested.

18 U.S. figures combine container and bulk cargoes. In addition, the U.S. Department of Commerce publishes statistics on movements of U.S. cargo through Canadian ports but not vice versa. According to the Maritime Administration, 1.2 million metric tons of U.S. exports valued at $2.1 billion and 982,000 tons of U.S. imports, valued at $2.2 billion moved through Canadian ports in 1980. The export tonnage was up 33 per cent from 1979, while import tonnage was down 20 per cent. See U.S. Department of Transportation 1983.

19 The recession also appears to have interacted with certain pension and pension-equivalent provisions of labour contracts at U.S. East Coast ports to push up surcharges on cargoes going through such ports as New York – all to the benefit of Montreal. 'Surely the rise in minibridge and the tremendous growth in cargo at Montreal are largely attributable to the differences (in labour costs) that already exist. The danger is that ever greater cost-differentials will just lead to more and more cargo diversions.' See Armbruster 1983.

20 Pelkola, D.W., Transportation and Communications Division, Department of External Affairs, Ottawa, personal communication, 4 August 1983.

21 Following financial difficulties, Cast has recently been restructured and merged with a former competitor, Sofati Container. The restructuring completed separation of Cast Container from Eurocanadian Shipholdings. Eurocanadian has been placed in receivership by the primary creditor, Royal Bank, but no changes are planned in Cast operations. See Gibbens 1983.

22 The port of Detroit, oddly, has benefited from the new shipping patterns as containers are placed on railroad cars on barges in Detroit, and then floated across the Detroit River, where the cars are made into trains for Canadian ports. See Auwers 1983.

23 Sea-Land insists that their service is primarily aimed at Canadian traffic.

24 According to a spokesman, 'Cast's efficiency is based on a true door-to-door intermodal service and simplified documentation.' *Traffic World*, 20 July 1981, 38-9.

25 For a description of the previous and current wave of cargo diversion bills, see Nealse 1983 and Salzano (1981, 1983).

26 This does not mean that U.S. port interests have been completely unsuccessful in their attempts to reduce the flow of U.S. cargo

through Canadian ports. In 1979 foreign freight bills were rolled into dutiable value of imports, one affect of which was to put the Canadians at more of a disadvantage vis-a-vis U.S. ports. From Klymchuk, Andy, Office of Strategic Policy, Transport Canada, personal communication, 5 August 1983.

27 Pelkola, D.W., Transportation and Communications Division, Department of External Affairs, Ottawa personal communication, 4 August 1983.

28 *Traffic World*, 27 June 1983 and 30 May 1983. Unlike the Senate bills, the Administration proposes a ton-mile tax to finance inland waterway (as opposed to port) improvements.

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– (1983) 'C&NW hits ICC ruling in GTW takeover case', 7 February, 76

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– (1983) 'Canadian government plans to spend billions to upgrade western rails, 7 February, 77

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– (1983) 'Administration announces user fee program, sends proposal to Congress', 30 May

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– (1983) 'ATA informs Ontario body of continued imbalance of U.S.-Canadian truck rights', 11 July, 5

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Comments

Harold Handerson,
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My task is nominally an easy one: to comment on the paper prepared by Dr. Boyer. However, the conference organizers said that I should not feel constrained to limit myself to points raised in that paper. Therefore, it will not do to simply state that the Boyer paper is generally excellent, and resume my seat.

Since I have in effect been given license to roam, I will first provide a personal gloss on the Boyer paper, then suggest some additional matters that may be worth keeping in mind because of their direct and indirect impacts on the provision of cross-border transportation service.

The Boyer paper

In his 63 pages of draft text, Professor Boyer has made good use of materials from over two dozen other writers, including those for the *New York Times*, *The Wall Street Journal*, *Traffic World* (which I no longer see on a regular basis) and the *Globe and Mail* (which I regrettably had not previously seen). A few pages into the text, for example, he quotes Stanbury and Thompson (though the introduction to the quotation might more felicitously cite 'responsibility' before 'freedom') as follows: 'There does not exist in Canada any fundamental belief in the virtues of competition as a method of allocating scarce resources'.[1]

I was surprised that Boyer did not reject the contention that U.S. domestic rates could be used to cross-subsidize Canadian operations; nor to note that regardless of the reason for St. Johnsbury rate cuts, that clear benefit does lie with Canadian shippers and consignees. There may be some minor errors (e.g., citing the 'National Transportation Act of 1966'), and the reversal of the time frame with respect to congressional action and the Brock-Gotlieb letters of understanding mentioned under the section entitled 'U.S. truckers to induce changes in Canadian trade'[2], and potential misperceptions (e.g., citing Chow as to why U.S. truckers have been quiet about changes in regulation – which they do not see as affecting them); but the thrust of the paper appears to me to be correct: that regulation imposes excess costs on the broader public which can only be justified on the basis of broader national interests such as regional development or economic stability; and that cross-border divergences breed problems.

As we are currently seeing with respect to the new Crow's Nest Pass rate legislation, however, these costs may in fact become too large for some sectors (in this case, the rail lines) to offset. Even where they are not so large or so well documented, they entail an economic drag on those who must bear them. There are, for example, costs now borne by Canadian shippers and receivers of goods which pay the salaries of those Ontarians which the Truckers' Association says would be 'lost' if U.S. carriers were allowed freer entry into the Ontario market.[3] The jobs could only be lost if the service which is currently foregone was in fact of at least equal quality, and lower cost. The question then becomes one of both economics and politics, since the economists would say that those people should (eventually) be employed elsewhere in the economy, while the politicians would be concerned about their reaction in the meantime.

This in turn raises a point worth underlining: while even the U.S. firms with existing Canadian operating authority would agree that market demand increases as rates drop, they would not, *ipso facto*, support freer entry into Canadian markets. Therefore, politicians with the best interests of their constituents at heart must press for and promulgate better information on the costs and benefits of the current system and its alternatives, to build public understanding and support for actions which are in the public interest over the long run. At the same time, extreme care must be taken, *and publicly perceived*, that transition arrangements do not unduly put anyone at a disadvantage. Both these points are more easily made in theory than implemented in practice; but the second is perhaps the trickier of the two.[4]

It seems to me that, like it or not, the fact that the U.S. has changed its regulatory approach is a factor to which Canada will have to adjust. The manner and extent of that adjustment is not yet clear. However, it is unfortunate that the Foreign Investment Review Agency (FIRA) can make stipulations which are unacceptable to the provincial trucking regulatory authorities, for example, the original application of Roadway to purchase Herkema Express (Ontario). The ensuing muddle not only looks bad, it is the type of waste of resources which produces cross-border ill feelings rather than efficient transportation service.

In summary, the Boyer paper highlights the problems of economic inefficiency and political intractability which characterize the modal operations under cross-border regulatory regimes which are at variance with each other. It is the fullest and best treatment of the subject I have seen. The implications I have drawn are simple: better economic impact information, widely disseminated, can lead to politically palatable adjustments in the best interests of the general public (if not to the complete satisfaction of all parties at interest), and further expansion of efficient cross-border transportation service.

Other selected factors

Having given you my 'bottom line' on the Boyer paper, let me mention several additional classes of political-economic factors that will bear attention over the coming months and years.

The first class is transport-related and largely focused on domestic situations. Some have suggested, for example, that our current concerns regarding Canadian trucking arise because we didn't pay enough attention to the topic at the time we were trying to deregulate U.S. domestic trucking. If this is so, then the prospective simplification of truck fees by federal action[5] (perhaps with some sort of sharing arrangements for replacement of state revenue which may be foregone) will provide another opportunity to either include or exclude Canadian-based truckers from explicit consideration. I might note here that so long as the Canadian federal government chooses not to establish federal regulations with regard to extra-provincial trucking, it would seem to me that Canada will be at a disadvantage in making representations in such matters to the U.S.

A second type of problem is that posed by action in respect to one mode in either of our countries that may impact other modes in both of them. Raising the ceiling on Crow's Nest Pass rail rates may (and probably will) have effects on port traffic and the St. Lawrence Seaway with implications for other transport fees, subsidies or investment.[6] Exclusion of trucking as an entire sector from FIRA review is at least in theory a possibility, though it is currently the only way in which federal concerns are certain to be applied.

The final class of problems I would mention is caused for transportation by actions taken to serve other purposes.

One of my responsibilities is to represent the U.S. in multilateral transport facilitation matters in Geneva.[7] Import and export documentation, and Customs and Immigration checks for illegal movements of goods and people impose costs and delays on otherwise free flows. Our friends in Agriculture, Customs and Immigration have been taking significant steps to simplify or eliminate some previous requirements, but some irritants still remain; and sometimes the best that can be done is simply to share perceptions and concerns in a nonconfrontational manner. Sometimes this discussion is more productive, since it can help us, and devise methods of meeting all parties' desires and needs in a better way than before the discussion began.

Concerns over trade balances or the value of the dollar – American or Canadian – can result in the imposition or maintenance of obstacles or outright bars to the free flow of investments and purchases of goods and services; and transportation is typically affected, at least indirectly.[8] In this regard, let me mention FIRA one last time. I would suggest that so long as FIRA is something more than a monitoring operation, it will discourage some of the foreign investment that Robert Logan says you will continue to need;[9] and will certainly have two other costs: the cost of preparing and processing the applications that are made; and the psychic costs of absorbing the sniping that is delivered in even this friendly atmosphere.

As relatively well-to-do countries, both Canada and the U.S. will continue to experience pressures from lower-cost purveyors of goods and services based elsewhere in the world,[10] as well as continuing pressures, foreign and domestic, from those seeking to protect or improve their existing situation. Thus, the prospects for a full agenda for the Third Annual Workshop appear bright.

NOTES

1 In contrast, I might quote Agriculture Secretary Block, speaking at the Agriculture Outlook Conference in Washington, 31 October. 'I am not proposing that we get government entirely out of agriculture. A safety net of some kind is necessary. I am just saying that the government does a poor job of allocating resources. Government is ill-equipped to accurately set prices. The true signals that farmers should respond to are market forces undistorted by government interference.'

2 The latter point already noted by Michael Brock.

3 Report of the Ontario Highway Transport Board to the Honourable James W. Snow, Minister of Transportation and Communications on 'The Balance of Trade in International Trucking Services Between the United States of America and Canada' (Toronto, 30 July 1983), page 5 schedule G; cited and discussed at pp. 30-1 (also referred to by Boyer).

4 See Chapter 15 of Conrad Winn and John McMenemy (1976) *Political Parties in Canada* (Toronto: McGraw-Hill Ryerson) as to why neither is probable: basically, one is giving hostages to fortune by developing information which may be adverse to one's own (or one's supporters') position. Royal Commissions, however, may be exceptions to this general line of reasoning.

5 To meet the requirement of section 19 of the Motor Carrier Act of 1980 (P.L. 96-296). Promised by Secretary of Transportation Dole in a speech to the Highway Users Federation; and reported in the 4 November 1983 issue of *The Journal of Commerce*. (The current Congressional mandate placed on the Department of Transportation by Public Law 98-369, is to conduct three studies in this area, and to report to the Congress no later than 1 October 1987. One of these studies, under Section 932, is focused on cross-border impacts of imposition of the U.S. heavy vehicle use tax.)

6 When I mentioned this yesterday, John Curtis, sitting on my right, immediately muttered something about Mississippi River barge traffic. See also Boyer on mergers and long-hauling.

7 For this reason, I particularly liked Boyer's introductory paragraph on 'Economic issues in the regulation of cross-border trucking'.

8 The IMF reports that the value of total industrial country exports for the first quarter of 1983 was 5.6 per cent below the prior year, despite an upturn in March. The impact on transport operations is clear.

9 Although a report in *The Journal of Commerce* of 10 November states that net foreign investment in Canada has again turned positive: $250 million for the first six months of 1983.

10 My exhortation to be attentive to this broader perspective had been anticipated by several other participants, even before Ambassador Warren drew our attention to the subtitle of the workshop in his remarks last night.

Comments

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I appreciate the opportunity to comment on Professor Boyer's paper which is a very useful contribution to discussion of Canada/U.S. transportation issues. I look forward to any observations that come out of the discussion.

Several years ago transportation would have been an unlikely topic for a workshop on frictions in the relationship. The system worked. The Seaway was often cited as a model of international co-operation. Now, however, as Professor Boyer has made clear, things have changed and there are some problems and policy makers have had to focus more on the transportation relationship. (The Seaway, for example, has twice in the past few months been the subject of diplomatic communications by Canada in response to U.S. initiatives which Canada feels could threaten this close co-operation.) This said, I do not think we should lose sight of the fact that the system does still work – the transportation network still facilitates the largest amount of trade in the world between two countries – and the largest movement of people across its borders. I would like first to make several general observations, after which I will make some selective specific comments on the various modes described in the paper to try to illustrate my general observations.

I think the paper provides a good catalogue and summary of the major issues in the transportation relationship and while Dr. Boyer adds a disclaimer, I think his study is remarkably comprehensive. I cannot quarrel with the basic position that differences in regulation lie at the base of many of the Canada/U.S. transportation issues, although I am less certain that resulting frictions or solutions can be seen purely in terms of the economic efficiency of the transportation sector alone. I think it is worth noting that international regulatory conflicts are a relatively recent phenomenon and problems can result from the fact that very often the players do not understand the purposes which regulation serves in the other country. In addition, there is no simple procedure for how we resolve disputes.

While there is a growing tendency to see transportation as a service which can be traded and measured much like a traded good, in Canada, historically, transportation policy has responded to unique political imperatives related to nation building flowing from factors of geography, population, resource development and, without doubt, of Canada's relationship with the United States. Professor Boyer notes that, until recently, the regulation of the transportation sectors in both countries was remarkably similar. There are, however, noteworthy differences in *approach* (to regulation) as a result of different forms of government and different approaches to economic development. Canadian governments (both federal and provincial) have been more directly involved than their U.S. counterparts in economic development and the provision of services through enterprises they owned or sponsored. In the U.S., private enterprises have tended to fulfil this role. Accordingly, in the U.S., a complex regulatory system was developed to oversee private activities which were perceived to be abusing their economic power. In Canada, on the other hand, governments have the ability to control directly many services because they own them. As a result there has probably tended to be less regulation in Canada than in the U.S. Another important fact is that regulatory agencies in the U.S. tend to enjoy considerable autonomy from the executive branch and even the legislative branch. This is much less true in Canada and Canadian political traditions have developed in a way which points to the government of the day for management of public policy issues. There is, for example, often an appeal from regulatory bodies to Cabinet. This has resulted in a more consensual and less adversarial approach in Canada than exists in the United States.

Canadian governments have, however, recognized the need to balance the use of the transportation system as an instrument of national policy (through both ownership and regulation) against commercial forces. The trend, over the past 20 years, has been toward less regulation. However, in keeping with its approach to economic questions in general, Canada has proceeded carefully in an effort to maintain a national consensus on the proper role for the regulatory system which is intimately tied to Canadian national development. National interest is *not*, though, a set of static objectives. Rather, it is a process, a process of redefinition. This approach to regulation has permitted a regulatory system in Canada which enabled it to respond to intermodal competition, as Professor Boyer states, with the National Transportation Act, parts of which were adopted as a model for the Staggers Act which deregulated rail in the U.S. almost 15 years later. The Canadian system of regulation has been, and is, an evolving one, responding to a number of factors, but not always to the dictates of economic efficiency alone. The latest example of this evolution, and an example that in Canada transport is more than 'just another sector' where pure economic efficiency for the transportation sector governs all, has been the debate on the Crow rate. Other economic goals – in this case Canada's grain trade – influence transportation policy. The Canadian system, then, is evolving. The current problems, as Dr. Boyer has described, have resulted from sudden and broad changes, under the banner of economic efficiency, in the U.S. system. The challenge, therefore, facing Canada is how to respond to the changing situation, taking into account the types and mix of broad national interests (which have determined changes in the past). In assessing the challenge and the future, I think it is, therefore, important to recognize the context of Canadian transportation policy in order to understand and manage the specific issues and problems.

I would like now to make some specific and selective comments on the various modes described in the paper.

Trucking

With regard to *trucking* which first raised the profile of transportation services as an area of dispute, I think it is fair to say that the regulatory systems in Canada and the U.S. *were* similar in many ways with regard to trucking, but I think it is worth noting, to demonstrate what I have just said about Canada's having less regulation, that there is the general view in the trucking industry that the U.S. system was, in fact, more restrictive than the Canadian. While there is no doubt that the reverse is now true, it would be more accurate to say that the U.S. system caught up and overtook the Canadian system all at once rather than to imply we were starting from the same place.

My main comment on trucking relates to the moratorium which shows the importance of understanding differences, in order to prevent such costly disputes. The moratorium did not, in fact, occur following the signing of a letter of understanding between the two countries. The opposite is true. In early 1982 the ICC, in response to U.S. trucking concerns about increased entry of Canadians into the U.S. market following deregulation and to claims of discrimination by Canada, stopped processing Canadian applications while it undertook a study of the issue. While the study was underway, Congress, responding to similar pressure, legislated a moratorium, despite strenuous Canadian government efforts to explain that Canada did not discriminate. (It is interesting that Canadian provinces had great difficulty in preparing material for the ICC study because applications were not filed by the applicants' country of domicile.) When he signed the law, President Reagan asked Ambassador Brock to negotiate an understanding on trucking with Canada that would permit him to lift the moratorium. During the negotiations the ICC released its report. Although it found Canadian regulations somewhat more restrictive, it concluded that Canada did not discriminate. The year-long dispute had cost the Canadian industry heavily in lost business and legal fees. The consultative mechanism set up by the Understanding aims to focus industry complaints, bring them to governments' attention – a sort of early warning system – to prevent precipitous unilateral retaliatory action resulting from an imperfect understanding of each other's regulatory system. I think it is particularly important to manage grievances – or perceived grievances – in this way, as Canadian jurisdictions study their legislation and make decisions on the reform of their regulatory systems.

Air

The section of the paper on *air* addresses an extremely complex relationship – by far the most complex bilateral air relationship in the world. In view of the fact, I think it must be emphasized that for such a relationship, it works rather well. I do not share entirely Dr. Boyer's position that Canada treats the relationship as a diplomatic rather than an economic one – although certainly we have different views on what is economic. I think the paper incorrectly implies that Canadian airlines are inefficient tools of government policy. Canadian lines are certainly more efficient than U.S. airlines *were* and are probably the most efficient non-U.S. lines in the world now. Canadian lines can compete with U.S. lines for Canadian traffic to the Caribbean, for example, where geography makes such competition inevitable. U.S. lines get about 20 per cent of such traffic – Canada does not complain. These so-called 'sixth freedom rights' are not negotiated in the international air system as the paper suggests under the discussion of the Continental seat sale. In his description of that case, I think Dr. Boyer reflects well the CAB position but not that of Canada – or perhaps other U.S. agencies. Canada would not object if Continental attracted Canadian passengers from Los Angeles to Australia, just as Canada does not object to the U.S. lines attracting Canadians flying on U.S. lines to the Caribbean from New York. Canada can compete. However, in the Continental case, that airline was offering fares to Canadians only from Canada to Australia (which were not available to Americans) and which were below the fare available to Americans to fly the same route to Australia from the U.S. In principle, Canada would have been able to compete but was, in this case, unlike in the Caribbean, restricted in the flexibility it had as a result of its bilateral agreement with Australia which imposes capacity controls.

The paper refers to the Preclearance Agreement but omits to mention the importance of preclearance facilities. The Preclearance Agreement, which permits Canadians to clear U.S. Customs in Canada before travelling to the U.S., was a result of diplomatic negotiation and provides an extremely important economic advantage to U.S. airlines as well as a convenience to passengers. With passengers cleared in Canada, flights to the U.S. essentially become domestic flights. The lucrative Toronto-Atlanta flight mentioned in the paper does not, for example, exist as a negotiated route. It is a Toronto-Buffalo flight which, as a result of preclearance, can continue as if it were domestic. One final word on air. The fact that fares under the bilateral agreement can be disallowed by either side enables the CAB or CTC to disallow certain rates. CAB practice has tended to keep fares down to the extent that some transborder fares are lower than domestic ones.

Rail

The paper recognizes the importance of the Canadian National Transportation Act in recognizing early intermodal competition and in permitting Canadian railroads to operate on a more commercial and competitive basis. Canadian railways were, as a result, much more efficient than U.S. roads. *This* was the reason why traffic in the 70s could be routed from Europe to Chicago via Winnipeg. I do not think it was because of the practice of long-hauling, as Dr. Boyer suggested in his paper. Canadian roads offered better service at a time when U.S. railroads were very inefficient. Use of Canadian roads as a result cannot appropriately be termed 'bizarre' behaviour.

Conclusion

I would like to make a few final observations. From the perspective of a department which must manage the frictions in the transportation relationship to try to minimize their impact on the system, on trade and on Canada/U.S. relations in general, I think we must be careful to recognize why differences exist – what, for example, are the Canadian reasons for Canadian policies. We also need to keep in mind how broad and complex and, in fact, good, the transportation relationship is. And taking these factors into account, I think that policy makers, in managing the transportation issues, need to keep in mind, above all, that in Canada (and, in fact, in the U.S. as well), transportation has responded, and I think will continue to respond, to more than pure economic efficiency. Equally, we should understand that it is an evolving, developing system which does respond to commercial pressures and which is less regulated and more efficient than in most countries. The challenge is to work out ways for it to continue to respond to national interests in light of rapid changes in the situation in the U.S.

Canada/U.S. tax relations: issues and perspectives

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Few questions are more complex, technical, and intractable than those arising with respect to international tax relations. The inevitably simplistic models conventionally used in economics to explain and understand reality often bear so little relation to the real world of international economic affairs as to be useless. On the other hand, attempts to depict the reality of the international tax scene in institutional and legal detail quickly become so complex as to be equally useless as a guide to analysis. Furthermore, international tax issues can really be understood or analysed meaningfully only in the context of a much broader range of questions concerning international, economic and political relations.

In no country can tax policy be understood solely in economic or technical terms: when two countries *and* the relations between them are involved, matters tend to become even more complicated. And when the two countries interact on as many dimensions as do Canada and the United States, attempts to compartmentalize any one issue such as tax policy, are more likely to obscure than to facilitate understanding: witness the catalogue of apparently irrelevant issues that has held up ratification of the latest Canada/U.S. tax treaty for several years.

International taxation has become especially complex and interdependent in recent decades. As the national economies of the industrial world have become increasingly linked through flows of goods, capital and people, the role of governments and consequently of taxes has expanded everywhere. How any one country chooses to tax (and to spend) this increasingly affects other countries through its effects on trade and factor flows. To paraphrase John Donne, today more than ever 'no country is an Island, entire of itself, every country is a piece of the Continent, a part of the main'.

No two countries are more closely related economically than Canada and the United States. Trade and factor flows across the Canada/U.S. border exceed in volume and value those between any two countries in the world. In terms of the number of individuals and firms affected, the impending Canada/U.S. tax treaty is the single most important tax treaty in the world. Nevertheless, U.S. *domestic* tax policy probably has even more important effects on the welfare of Canadians through its effects on trade and factor flows than do formal Canada/U.S. international tax relations.

Our concern in this paper is to place in better perspective a few selected issues in current Canada/U.S. tax relations. Treaty shopping, the unitary approach, and a few of the other issues we mention in this brief and selective review may be at the forefront of international tax discussion today, but they are in fact substantially less important in determining the state of Canada/U.S. tax relations than the basic economic facts of life on the North American continent and the general vagaries of a volatile world. While such factors of course affect both countries, the much greater size of the United States insulates it to some degree – a difference which goes far to explain both the state of Canada/U.S. tax relations and their future prospects.

THE CANADA/U.S. TAX TREATY

Perhaps the best place to begin a discussion of Canada/U.S. tax regulations is with the most recent concrete manifestation of those relations – the impending revised income tax treaty. It is now eleven years since negotiations for a new tax treaty to replace the 1942 treaty began, and almost four years since they were, it appeared, concluded. Despite the subsequent conclusion (in June 1983) of an important Protocol amending the treaty agreed in 1980, the treaty has still not been ratified, with the result that the tax aspects of the most substantial cross-border flows in the world are still governed by a treaty drawn up in wartime over forty years ago. There can be few other areas in the modern world where the game has changed so much while the rules have remained unaltered:[1] it is as if the tax authorities were air traffic controllers guiding 747s into New York with rules designed for Kitty Hawk.

Any tax treaty can be viewed from several perspectives. In its legal dimension, for example, it is a contract between nations which does not come into effect unless and until appropriate legislation is enacted within each nation: the resulting legal documents, like all laws, of course reflect the political objectives and constraints in each country. As far as international investors and entrepreneurs are concerned, a tax treaty is a comprehensive set of rules defining their tax liabilities. In this sense, a tax treaty is a bilaterally-coordinated tax system, complementing or accommodating the basic international aspects of different domestic income tax systems – those relating to the taxation of foreign-source income and income of non-residents. Its purpose is both to preserve the integrity of the domestic tax system and to reconcile that system with different systems of other countries. Finally, the rules, rates and regulations embodied in a tax treaty have international economic implications. The terms of a treaty both affect the international allocation of capital, labour and technology and determine the international division of the tax base.

Each country's approach to treaty negotiations reflects its attitudes and interests with respect to international flows of capital, its desire to get a goods share of the tax revenues generated by foreigners, the political influence of its capital exporters and importers, and – by no means least – the strength of its desire for better relationships in general with its potential treaty partner. Since these factors may change from time to time, and negotiation to negotiation, it is not always easy to pin down exactly why a provision in a treaty between countries *X* and *Y* is inconsistent with one in a treaty between *X* and *Z*. In the case of the recent Canada/U.S. treaty negotiations, however, each side appears for the most part to have played its customary and expected role.

Canada's approach appears to have been shaped largely by its traditional desires as a significant importer of capital from abroad both to safeguard its revenue position and to strengthen domestic ownership (Coulombe 1977; Cantor 1981). For these reasons Canada reserved its position on the 'non-discrimination' article of OECD model tax convention and asserted its intention to levy higher withholding taxes on dividends, royalties, and interest than provided for in the model treaty (OECD 1977).

The OECD model treaty – like the closely related U.S. model unveiled a few years later – clearly reflects the dominant influence of capital-exporting nations in that it generally favours tax reductions in the country of source and unrestricted taxation in the country of residence. Net capital importers obviously stand to lose tax revenue from shifting to taxation based on residence rather than source or from any equal reciprocal reduction in withholding tax rates. Even though Canada has in fact been a net capital *exporter* for a number of years now, the *stock* of foreign-owned capital in Canada is still much larger than the stock of Canadian-owned capital abroad, and it is the relative size of these stocks that governs the size of the income flows subject to tax.[2] Canada was therefore bound to lose from the reduction in the withholding tax on dividends to 10 per cent negotiated in the new Canada/U.S. treaty. Moreover, the revenues thus forgone would, for the most part, flow directly to the U.S. Treasury, not to the taxpayers, and would hence have little or no effect on capital flows (Deutsch and Jenkins 1982).

One reason Canada was willing to make this concession was perhaps to fend off the constant U.S. criticism of its refusal to extend the dividend tax credit to non-resident shareholders as 'discriminatory' (Patrick 1981; Burge and Brown 1979). In treaty negotiations, the U.S. generally follows its traditional line – unsurprisingly for the country with the largest stock of capital abroad – of attempting to bargain down withholding rates and to follow the OECD principles of nondiscrimination and reciprocal concessions. The U.S. had, for example, successfully persuaded the United Kingdom to extend its dividend credit to certain American investors in the U.K.-U.S. treaty concluded in the 1970s. It has also in general steadfastly maintained its position that 'nondiscrimination' requires countries providing dividend relief to domestic shareholders to do the same for foreign shareholders (Carlson 1980).[3] The lower treaty withholding tax rate was thus, in the words of one of Canada's principal negotiators, 'a resolution of a fundamental issue by way of a concession in the rates of tax'.[4] As this example makes clear, no single feature of a complex international agreement like the Canada/U.S. treaty can be understood in isolation from the document as a whole – or, for that matter, from the prevailing context of Canada/U.S. relations at many levels.[5]

As in all bargaining situations, at the apparent end of the tortuous and prolonged negotiation process in 1980, both sides no doubt felt they had 'lost' in some respects and 'won' in others, but that on the whole they could live with the results. Why, then, has the treaty not been ratified? The original reasons for delaying ratification were apparently in part not necessarily connected with tax issues as such, but rather with such fundamentally extraneous issues as disputes about fisheries, the resolution of which was linked to ratification of the treaty by some, as well as the more closely related dispute on border broadcasting (Brown 1982). The U.S. political system, with its requirement for Senate approval of treaties, invariably results in delays of this sort as hard-won international agreements are reargued in terms of U.S. domestic political concerns, often dragging in technically irrelevant 'linkage' arguments. All countries recognize this fact of life in dealing with the U.S., however, and it is probable that in time the tax treaty will survive the fray and be ratified with at most minor amendments.

The willingness of countries to restrict their tax jurisdiction by treaty essentially depends upon the reciprocal nature of the agreement and their desire to encourage international investment. When investment flows between countries are approximately equal, or when there is a strong desire to encourage the free movement of capital, there is a strong incentive to negotiate tax treaties. The less these conditions hold, the less strong the incentive to make a deal. In the case of Canada and the U.S., the volume of trade and investment flows in effect requires an international tax convention to provide a certain degree of stability to these important external relations. The lesser importance of these flows to the U.S. than to Canada was perhaps offset in part by the traditionally greater desire on the part of the U.S. to encourage international capital flows. Canada is more dependent on such flows but, for that very reason perhaps, is more ambivalent about them.[6] The basic imbalance in the position of the two countries makes an acceptable division of tax base and agreement on general rules particularly difficult, however, so it is hardly surprising that it took so long to reach even the present flawed compromise. Moreover, since international tax affairs are never static, it is also not surprising that several new issues have surfaced (or resurfaced) since the treaty was originally concluded. Two such issues are discussed briefly here: treaty shopping and treaty calcification.

Treaty Shopping

The U.S. has become so worried recently about 'treaty shopping' – a term applied to the search for soft spots in international tax law – that it succeeded in having a new 'anti-shopping' provision adopted in the June 1983 Protocol to the Treaty. Although the main U.S. concern seems to be about Canadians being 'third parties' to U.S. treaties with other nations, they are also obviously concerned to ensure that the Canada/U.S. treaty cannot similarly be 'subverted' by others.

The scope for international tax planning by firms, which in principle is constrained by legal definitions and rules and by tax rates, is in practice broadened considerably by the fungibility of international capital, by the inherently imprecise and arbitrary nature of accounting methods, and by the difficulties of international tax auditing and verification. The importance of international tax planning through third-party manoeuvres is evidenced, for example, by the swollen investment position in tax havens. The U.S. Treasury reports that in 1981 $7 billion (U.S.) of corporate income was paid from U.S. sources to nonresident aliens (corporations outside the U.S.). $2.5 billion of this (36 per cent) was paid to the Netherlands and the Netherland Antilles, with more than half going to the latter. If four additional tax havens (the Bahamas, Bermuda, Panama and Switzerland) are included, the share of U.S. corporate income paid abroad from U.S. sources that flows to these countries is very close to half of the total (Carson 1983).

Canadian companies certainly play these games. Consider, for example, the so-called 'Dutch Treat', a typical arrangement under which a Canadian corporation channels its investments in the U.S. through a holding company in the Netherlands or Netherlands Antilles (McCart 1982). Under the terms of the U.S.-Netherlands treaty, dividends paid from the U.S. to the Netherlands bear only 5 per cent U.S. withholding tax. Normally, no additional tax is incurred on the second leg of the financial transfer to Canada owing to the way the Canadian system of taxing income flows from abroad works. In contrast, under the present treaty a U.S. withholding tax of 15 per cent is levied on U.S. source dividends flowing directly to Canada (to be lowered 10 per cent under the new treaty).

Canadian corporations have also made extensive use of the so-called 'Double Dip'. Through this triangular arrangement – again involving a parent company, an offshore financial subsidiary in a tax haven and an operating subsidiary in a third country such as the Canada/U.S. companies again exploit favourable terms in a bilateral treaty between other nations. The parent corporation borrows in

Canada and takes the usual interest deduction. The funds are then transferred at zero interest to a financial subsidiary – typically located in, say, the Netherlands Antilles – which in turn on-loans the funds at commercial rates to the operating subsidiary in the U.S. The latter is then able to claim an interest deduction in the U.S. on the same debt for which a deduction was previously claimed by the parent in Canada. The second flow of interest payments accrues as tax-free income to the financial subsidiary in the tax haven. The net effect of the Double Dip is that foreign investment is financed with Canadian debt capital which, because of the double deduction of interest, is effectively costless to the corporation.

Moreover, regardless of any intermediate financial manoeuvres to take advantage of the Dutch Treat or the Double Dip (or both), the income of the operating subsidiary in the U.S. can be repatriated tax-free as intra-corporate dividends to the Canadian parent under Canada's 'exempt surplus' provisions. Finally, the interest income which accrues in the tax haven may also eventually be repatriated to Canada tax-free. Such tactics obviously increase the consolidated after-tax income of the multinational corporation and impose a corresponding tax revenue cost on Canada and/or the U.S., split in a way that is not very clear.

To ensure that the new Canada/U.S. treaty does not create additional opportunities for such circuitous tax planning which could be costly to the U.S. Treasury, significant tightening of the anti-abuse provisions of the new treaty with respect to third party use in the form of protective clauses (so-called 'control tests') similar to those already in force in the U.S.-Australia and U.S.-New Zealand treaties were accepted by Canada in the 1983 Protocol. Although one may perhaps wonder why the U.S. is so concerned with third party use of the Canada/U.S. treaty – in view of its higher than average withholding tax rates, a third party looking for a good deal would likely go elsewhere – for certain categories of international payments there may be some potential abuse. Copyright royalties, for example, are exempt from withholding tax between Canada and the United States.

The increased recent U.S. concern with the potential use of tax treaties by third parties may in part reflect recognition by the United States that since it is now a net capital-importer its interests no longer automatically lie on the side of the most open and tax-free flow of international investment funds, as they were perhaps thought to do in the heyday of American economic dominance of the western world. From the perspective of a large capital-importing country, the optimal level of foreign investment is generally less than the unconstrained, market-determined level. A tax on the earnings of foreign-owned capital will therefore generally be in the interest of such a country.[7]

The fiscal integrity of an open economy obviously requires vigilance with respect to the opportunities taxpayers have to shift income internationally to avoid tax. And defense of its tax system is unquestionably a national prerogative. No set of bilateral tax treaties, however, can be expected effectively and permanently to compartmentalize international capital flows, thus eliminating the scope for intermediate manœuvres involving third parties. In the complex real world, such bilateral compartments will be as arbitrary as they are insecure. International investments frequently involve pools of capital and a maze of intermediaries with a holding company serving as a nexus. The principles and application of international source rules are insufficiently precise to provide an unambiguously 'correct' allocation of the cost of highly fungible international intra-corporate finance. Strict rules to exclude third – or fourth or fifth – parties are likely to create administrative nightmares, with no assurance of improved efficiency. Even if a heavy-handed approach succeeded in blocking certain international financial manœuvres, desirable international investment flows might well suffer in the process. For example, a stricter U.S. policy could impose serious, unintended, and undesirable penalties on Canadian corporations that have arranged Eurobond financing of U.S. investments.[8]

Perhaps it is also time to reconsider Canada's position in the treaty game as well. In particular, Canada's recent shift in net international investment position may mark at least the beginning of the end of its prolonged dependence on capital imports and its emerging maturity as a capital exporter. If so, it may become less desirable for Canada to maintain its traditional insistence on high withholding rates as well as its reservations on the nondiscrimination rule. While Canada is surely within its sovereign rights to try to alter the exceptional degree of foreign ownership and intervention in its economy, by the same token, Canada must anticipate negative reaction to discriminatory treatment of foreign investors in, for example, the national energy program and FIRA. Demands such as the extension of the dividend tax credit to American investors may thus be reopened. Since international tax decisions, like all tax decisions, are hardly made in an atmosphere of analytical purity, Canadian discrimination in one area – even if grudgingly accepted – can be expected to elicit demands for offsetting 'nondiscrimination' elsewhere.

Treaty calcification

A tax treaty spells out in detail what specific items – expenses, deductions, royalties, revenues, sub-jurisdiction taxes – enter the source tax calculation and how they do so. Once a treaty is in force, these explicit definitions and regulations form the basis for calculating the tax liability in the source country and foreign tax credits in the residence country. Such definitions therefore ultimately determine both the effective tax rates applied to international investment and the international distribution of tax revenue.

Unless there is provision for *change* in interpretation, a signed and ratified treaty thus virtually stops the clock on accounting. Over time, accounting anachronisms may creep in, introducing inconsistencies, violations of national treatment, unintended double taxation or international loopholes with subsequent real and distributive consequences. In 1942, for example, provincial taxes were deductible in determining Canadian federal tax liability; in 1983 they are not deductible. Under the terms of the 1942 Canada/U.S. treaty, a U.S. investor in Canada might therefore be entitled to demand the deduction even though the federal rates have already in effect been adjusted to allow for the provincial taxes.

A recent decision by the Supreme Court of Canada on the *Melford* case clearly establishes the legal position in Canada (McDonnell 1982). The court ruled that undefined words in a tax treaty are to be understood to have the meaning they had at the date the tax treaty came into force. The high court's view was that a tax treaty is a contract between the participating states and its terms ought not to be open to unilateral amendment.

The implication of this Supreme Court decision is that subsequent amendment of Canadian tax law in any fashion which compromises the terms of the treaty (including all undefined words and expressions) as interpreted *at the date of signing* has no effect on activities falling within the scope of the treaty. In view of the threatening scope of this decision to a wide range of international business activities – not least between Canada and the U.S. – it is not surprising that soon after the Melford decision the Minister of State (Finance) tabled a Ways and Means Motion relating to the interpretation of Canada's tax treaties with other countries.

The proposed Income Tax Conventions Interpretations Act provides that to the extent a term in a tax treaty is not defined, or is defined by reference to Canadian domestic law, the term is to be given the meaning that it has for the purposes of the Income Tax Act *as amended* from time to time. The intent is obviously to ensure that for purposes of determining Canadian tax, the meaning of undefined words and expressions contained in Canada's tax treaties will evolve with changes made in Canadian tax law.[9]

Most recent conventions concluded by Canada already contain a specific provision regarding interpretation patterned on the 1977 OECD Model Double Taxation Convention. This general guideline does not, however, deal specifically with the problem addressed by the Supreme Court in the Melford case, namely, the relevant time at which the meaning of a word or expression is to be interpreted. The proposed Interpretations Act therefore provides that for the purposes of *Canadian* taxation the terms of a treaty are to be given the meaning that they have under the current reading of the Income Tax Act. From the government's point of view, the general language of a treaty is thus rendered fluid rather than petrified. (On the other hand, some taxpayers may consider the new Act to introduce an unwarranted retroactivity into treaty interpretation.)

This new approach is of course not intended to supplant the general rule of interpretation in Canada – the so-called 'treaty override' – which provides that in the event of any inconsistency between the provisions of a treaty and domestic law, the provisions of the treaty shall prevail. In contrast, this rule appears to have been less respected in some recent U.S. legislation and judicial decisions. Most bilateral tax treaties with the United States, for example, explicitly grant the country of residence the exclusive right to tax capital gains in real property. Thus, under the current (1942) Canada/U.S. tax treaty, gains in the value of property in the United States owned by Canadian residents are taxable by Canada. In December 1980, however, the United States passed The Foreign Investment in Real Property Act (FIRPTA) which in effect overthrew the residence Country's priority right to tax capital gains in real property as of 1985 at the latest (Feder and Parker 1981). Although by far the most numerous group of foreigners affected by this legislation were probably Canadians, the Canada/U.S. discussion of this legislation prior to its passage appears to have been confined to attempting to accommodate its envisaged shape within the new treaty.[10] The subsequent tangled history of the FIRPTA legislation and regulations (Alpert 1982) makes it hardly surprising that further adjustments to attain this end had to be included in the June 1983 Protocol to the Treaty.

A recent U.S. court decision also raises some questions about U.S. treaty interpretation rules. In *Great-West Life* the U.S. Court of Claims interpreted a section of the existing Canada/U.S. treaty in a very restrictive fashion, based largely on its interpretation of *U.S.* legislative history. As Roberts (1982) notes, this decision raises some question about the extent to which the U.S. judiciary can in effect revise treaty provisions to reflect developments in subsequent treaties and domestic law and whether, in light of the Vienna Convention on the Law of Treaties – signed but not ratified by the U.S. – such judicial interpretations of treaties should properly follow the usual U.S. judicial pattern of interpreting legislation guided by unilateral legislative history.

The treaty interpretation issue is relatively new on the scene and may seem relatively minor. Yet it is critical to the raison d'être of a tax treaty to reduce uncertainty in international tax matters. Uncertainty – especially if it entails unilateral modifications of the terms of a treaty – not only discourages the private sector but also prompts the tax authorities to protective posturing and destructive game playing. While it is a little hard to reconcile some recent U.S. developments with the traditional American insistence on the need for stable international tax rules favouring the free flow of capital – as evidenced by their current concern for the Melford issue in Canada – it seems unlikely that uncertainty on this matter will long delay the implementation of the pending treaty. What the treaty interpretation issue does suggest, however, is that some important aspects of the current treaty system still remain surprisingly unsettled. As one commentator has said: 'Since resolution of these issues may not be soon forthcoming, tax advisors and their clients are left in the uncomfortable position of knowing what the treaty provides but often of not knowing what it "means"' (Roberts 1982, 766). So much for resolving uncertainty.

SUBNATIONAL GOVERNMENTS AND THE UNITARY APPROACH

An important and virtually unique aspect of Canada/U.S. fiscal relations is that both countries are federal states, in which subnational governments – states and provinces – play an important, and largely independent, role in determining and implementing tax (and subsidy) policies.[11] Indeed, both countries explicitly entered reservations to a provision of the OECD model tax treaty which would have brought within the scope of international tax conventions the income taxes levied by state and provincial governments (Coulombe 1981). Nevertheless, the pending treaty clearly tries to encompass subnational taxes wherever possible, presumably in recognition of the problems that have arisen in the past with regard to such provincial levies as the Ontario mining tax (Deutsch and Jenkins 1982) and some state income taxes (Coulombe 1981).[12] The treaty does not, however, attempt to deal with the latest problem area in respect to subnational taxes – the so-called 'unitary approach'.[13]

The division of tax base amongst different jurisdictions has long been a central issue in international taxation. Traditionally, the principles followed in allocating tax base to different jurisdictions have been *transactional*, that is, they have depended upon the characteristics of particular transactions. The problems arising in this area include both those conventionally labelled 'transfer pricing' and such matters as the allocation of central overhead expenses. Both Canada and the United States have legislative provisions providing for the revenue authorities to adjust international transfer prices and expense allocations to reflect 'arm's length' transactions – that is, the amounts that would be reasonable in the circumstances had the parties had been dealing at arm's length. Inevitably, however, the integrity of national tax systems remains at risk given the inherent arbitrariness of such accounting exercises. The tangle of intra-firm transactions tends to favour multinational firms. Moreover, subnational governments are seldom as sanguine as national governments that they will receive their 'proper' share of tax revenue. In recent years, a number of U.S. states led by California have therefore taken a new tack in establishing their fair share of the corporate tax base – the unitary approach.

Conceptually, the unitary approach is simple. Income from any corporation taxed in jurisdictions employing this approach is assumed to be derived from a larger network of divisions/subsidiaries/affiliates (traditional intra-corporate distinctions fade in this exercise) scattered throughout the world. The taxable share of worldwide consolidated income is then calculated by applying a formula based on such standard apportionment factors as local sales *per cent* of consolidated sales and/or similar ratios for property and payroll, regardless of what conventional tax accounting statements might indicate.

One rationale for this approach is that since the profits of a unitary business arise from the operations of the business as a whole, it is misleading to characterize these profits as being derived from a set of distinct sources as under the traditional approach (Carlson and Galper 1982). Another rationale is that states are simply not in a position to evaluate the accounting data given them by multi-jurisdictional corporations and hence need to adopt some such arbitrary approach to avoid being left wholly at the mercy of the taxpayers.

The unitary approach contrasts sharply with conventional 'separate accounting' rules for appropriating corporate income among jurisdictions. Under the traditional approach, individual jurisdictions in effect do not look beyond their respective boundaries in calculating corporate income. Affiliated foreign corporations are thus treated as unrelated parties and domestic-source income is measured as if all 'off-shore' dealing reflects arm's length transactions between entities. In many instances, however, this approach does not provide an acceptable division of income of an integrated business between different tax jurisdictions. Because formula apportionment, as under the unitary approach, relies on direct measures of the share of selected income-producing factors located in the taxing jurisdiction which can be quantified on a relatively objective basis, tax administrators can avoid detailed and difficult enquiry into particular transactions characteristic of separate accounting.

On the other hand, formula apportionment may itself introduce significant distortion to the division of the tax base, especially if the productivity of factors differs substantially among the various jurisdictions involved. Differences in wage scales and in property costs are examples of disparities which may cause any apportionment formula to be distortive.

The unitary question has generated heated debate within the United States. The political issue is whether or not individual state governments have the right to tax on the unitary basis in light of potential extraterritoriality which might violate interstate commerce clauses of the Constitution and trespass on the federal mandate to maintain national uniformity in international commerce. Recently the U.S. Supreme Court affirmed states' rights in a landmark decision which upheld California's unitary method of taxing multinationals following a challenge from Container Corporation of America, a unit of Mobil Corporation. This ruling has encouraged other states to jump on the unitary bandwagon. Since the Supreme Court Ruling explicitly pertains to U.S.-based multinationals, it does not apply automatically to state taxes on domestic subsidiaries that have parent companies based in other countries. Nevertheless, the unitary tax has already been applied in some states (e.g., California) to subsidiaries of foreign companies (e.g., Alcan) operating in those states. The Supreme Court position seems to leave the states and the companies involved to deal with such problems on their own.[14] In reality, however, both federal governments are also involved, as is the painfully-arrived-at compromise on various international tax issues already embodied in the Canada/U.S. treaty. Unfortunately, the treaty mechanism has not been able to resolve the impasse in dealings with the U.S. caused by the conflict between intra-national jurisdictional arrangements (involving states' rights to tax) and the national commitment to international tax harmony.

The unitary question is only one instance of the broader question of the role of subnational governments in determining national policies in an open world economy. Just as the attempts of some Canadian provinces to devise particular systems of taxing natural resource industries (the Ontario Mining Tax) have to a considerable extent been shut down by American rules, so in the end the attempts of U.S. states to extend their jurisdiction beyond the 'water's edge' may be thwarted by international pressure.

Recently, Canadian tax authorities reaffirmed their emphasis on the transactional approach and made the following comments on the alternative of the unitary (or global) approach: 'we are reluctant to adopt a global approach to evaluating interaffiliate transactions because it is not specifically provided for in our legislation: it does not effectively highlight double charging: and, finally, we often do not have access to global corporate information' (Robertson 1983, 777). Perhaps for these reasons, Canada did no originally push the unitary issue very hard, although recently official attitudes appear to have hardened somewhat.

In any case, it seems unlikely that the unitary approach is going to go away. Quite apart from U.S. politics, the obvious attractiveness of the unitary approach to some developing countries may well lead to continued discussion on these matters in international forums in years to come. Even if the U.S. federal government takes a strong hand prohibiting states from applying such rules to foreign-based companies – and can enforce it – the growing complexity of international business and finance and the consequently increasing artificiality of the traditional transaction-based separate accounting approach requires serious consideration of issues raised by the unitary debate. Since any accounting rendition of a separate structure is necessarily arbitrary in part, as *must* be the case for an integrated multinational firm, the pressure for a formula approach to the international allocation of tax base will no doubt be as strong among nations as it has been within the U.S.

Perhaps the only way to avoid the problems that have given rise to this approach completely in any federal country would be to centralize the corporate income tax (McLure 1982). If so, it follows that the only way to avoid the development of a parallel movement internationally might be to move in some sense towards a 'world' tax authority. This prospect is no doubt sufficiently remote as to warrant no further discussion here: but what does perhaps bear more attention is the impossibility in an increasingly integrated world economy of any nation's resolving such issues unilaterally, or even bilaterally in conjunction with another nation. As with 'treaty shopping', what really seems to be required to deal with the problem is a more multilateral approach, perhaps even a multilateral tax treaty – and not just a multilaterally-agreed model treaty (with many reservations[15]). In the absence of agreement on such matters among the major participants in the world capital market, however, it seems unlikely that any significant changes in the present, rather messy, system can be expected in the future.

Returning to the more parochial concerns with which we started, the growing strength of the unitary movement in the U.S., like the growing interest in more independent provincial income taxes in Canada, seems likely to continue to confuse and confound any attempt by the respective national governments to tie a neat treaty ribbon around international tax relations at any point in time. The need for continued, reasonable, informed discussion of the impact of one country of measures in the other will therefore continue to be as or more important to Canada/U.S. tax relationships than words set down in a treaty.[16]

SUBSIDIES AND TRADE

The preceding discussion focused on a few relatively technical issues affecting international investment and for the most part discussed them within the context of the pending Canada/U.S. income tax treaty, the primary format for formal discussion on fiscal issues between the two countries. From a purely 'tax' point of view, matters such as treaty shopping and the unitary method are indeed both important current issues and significant in their own right. In terms of broader Canada/U.S. relations, however, such issues may seem minor, especially in view of the apparently increasing use in both countries by both national and subnational governments of various protectionist and subsidy measures intended to affect trade and investment flows in particular ways. The present section therefore surveys, much more selectively and more rapidly, a few issues arising from the fiscal manifestation of what has been called the 'new protectionism' (Lazar 1981).[17]

One area of continuing and potentially escalating conflict between Canada and the U.S. concerns the subsidization of investment, both directly and through the tax system. The U.S. has long taken the position in international negotiations that many, if not all, industry (or firm) specific tax incentives in some sense constitute unacceptable subsidies to exports (Bergsten 1979), and this position won a substantial amount of acceptance in the recent GATT agreement on subsidies.[18] Given the substantial amount of cross-border trade and investment flows it is not surprising that this issue has often arisen in Canada/U.S. relations.

From the U.S. view, the central issue here appears to be the allegedly unfair distortion in trade and factor flows resulting from what it considers 'excessive' subsidization since the U.S. seems able to find an 'injury' wherever it can find a 'subsidy'. From Canada's view, the problem is that the equity of the proposed U.S. remedies depends too often on the assumption that all countries are equal, when in the real world they clearly are not.

A classic example of the application of U.S. option is the well-known Michelin case, where the United States condemned as unfair and excessive export subsidization the regional development subsidies given to the Michelin company to locate its tire factory in Nova Scotia. Obviously, a world-scale tire manufacturing facility cannot be located in a region such as eastern Canada without most of its output being exported. On the other hand, several such plants could exist in the United States, given the greater size of its domestic market, with a much smaller part of their output being exported – even if those exports swamped the Canada market. So long as the United States considers subsidies to export-oriented firms and industries to be selective export subsidies, the system is obviously heavily biased against countries with a smaller domestic market such as Canada (Grey 1980). Unless this basic asymmetry in international trading and investment relations is recognized in some way, the continuing problems in this area between Canada and the United States seem unlikely to be worked out amicably.

What makes U.S. attempts to purge subsidization from the international economic world a bit hard to take is the uniquely U.S invention of the Domestic International Sales Corporation – DISC, or, its latest incarnation, the Foreign Sales Corporation or FSC (see 'DISC' 1983). This explicit marginal subsidy to exports through the tax system appears to have no direct parallel in any other industrial country. It amounts, in effect, to an application of the so-called territorial principle of income taxation – the principle under which some countries (e.g., France) exclude from the tax base the income their resident corporations earn abroad – to activity which takes place entirely within the territorial jurisdiction of the U.S. As far as Canada is concerned, most of the allocative effects on Canadian industry that would have been exerted by this subsidy have probably been offset by the manufacturing and processing credit (which, unlike DISC, is not an export-related subsidy) – see Hyndman 1974; Eden 1983[19] – but it is hard to see how a country which maintains a device like DISC in the face of repeated international condemnation can be quite as purist in international economic discussions as the United States has been with respect to subsidies.

Many Americans seem understandably reluctant to accept that the U.S. too is an open economy which must constrain its domestic tax actions, at least to some for fear of international tax consequences.

More surprisingly perhaps, some Canadians also, even more unrealistically, refuse to accept that Canada is, in world terms, only a small country. A former federal minister of finance for example, recently recommended that Canada should (1) grant a five-year tax holiday on profits earned on incremental exports of manufactured goods over and above those of some base period[20]; (2) appreciably increase the withholding tax on interest, dividends, management fees and royalties paid to foreigners; (3) impose a substantial tax on interest, dividends, etc. earned abroad whether such income is returned to Canada or not; and (4) give Canadian-controlled companies a 10 percentage point reduction in their tax rates to offset the alleged advantages of foreign-controlled subsidiaries (Gordon 1982).

The trouble with such recommendations is that, in the first place, they severely underrate the potential retaliatory scope of American (and other foreign) reaction,[21] and secondly – and more importantly – they neglect completely the reality of Canada's linkage to the North American capital market and probable severe effects on Canadian investment and savings as a result of such measures. An increased withholding tax on interest payments abroad, for example, will force up the cost of corporate capital in Canada, suppress the volume of foreign-source capital, and, through the erosion of the tax base as a result of the increased financial costs, may in the end, yield little if any revenue. As Brean (1984b) concludes, 'the evidence that "small" countries in international capital markets should not impose such taxes seems as clear as any issue in the field of international tax'.

Moreover, proposals such as those listed above also leave out of account the important reality that most such protectionist measures are likely to hurt Canadians as a group more than they will help particular subgroups. Even in the case of the United States, for example, the most recent study of DISC suggests that this subsidy has, on balance, resulted in a fall in total U.S. income and an outflow in capital from the United States (Mutti and Grubert 1983).[22] Curiously, if the DISC program did hurt the United States through its effects on the terms of trade it probably *helped* Canada. It does not follow, however, that a DISC-like program in *Canada* would help Canada: on the contrary, applying the same sort of reasoning suggests it might harm Canada. Why should Canadians offset possible gains from the follies of others by indulging in similar antics of their own?

The result cited above with respect to DISC is consistent with such other results of general equilibrium analysis as the argument in Whalley (1980) that the United States probably *gains* from the existence of distorting taxes on capital which improves its terms of trade (see also Goulder, Shoven and Whalley 1981). If it is correct that distorting taxes on capital in the United States lead to a domestic welfare gain, it of course follows that removal of these distortions will lead to a loss. Since Canada probably does not exert the same degree of influence upon its international terms of trade, however, the similar distorting taxes on the capital in Canada – mainly the corporate income tax – are unlikely to be equally beneficial. In the topsy-turvy interdependent world in which we live, what you see with regard to the immediate incidence and effects of tax-subsidy measures is very often *not* what you get in the long run. In particular, lessons drawn from the experience of such 'price-makers' as the U.S. still is (at least to some extent) can be applied only with great care, if at all, to the case of such 'price-takers' as Canada.[23]

So long as protectionism continues to run rampant in the world – that is, so long as the depressed state of most major economies persists – there will no doubt continue to be competitive subsidization games played. Canada seems bound to be the loser in any such contest with the U.S. (especially to the extent the U.S. sets the rules) because of the basic asymmetry in its economic relationship with its powerful neighbour.

The attitude of some countries to this problem might perhaps be stated as follows: 'In a world of dog eat dog, a dog that doesn't eat gets eaten'. This sort of 'survival of the fittest' attitude is questionable from Canada's point of view, however. Indeed, Canada may in the short run be best off to continue to go along with the United States as far as it reasonably can. From a longer-term point of view, Canada might perhaps be better off joining with other smaller countries to argue for greater *transparency* of protectionist measures – a position which the U.S. supports – but against *linkage* and *reciprocity* – positions which the U.S. also supports.

Since, for example, goods differ from services because of the generally greater cultural content of the latter, the linkage of treatment on services and treatment on goods proposed by the U.S. is not a particularly good idea, especially for Canada with its traditional cultural concerns.[24] Similarly, the U.S. emphasis on 'reciprocity' in part appears to reflect the belief of many Americans that the recent poor showing of U.S. manufactured exports in world trade is the result of nefarious subsidization schemes in the rest of the world – a belief supported by some exceptionally thin and superficial evidence.[25] As noted earlier, the American version of 'reciprocity' is often in practice biased in favour of larger, more powerful economies.[26] In general, since it is not the biggest economies that most need a peaceful international environment for survival, it is unlikely that the U.S. can be expected to lead the way out of the present worldwide mercantilistic spasm. Canada can hardly do so either. But from Canada's point of view fostering a more altruistic and co-operative attitude in the world as a whole with respect to such issues, even at the expense of some short-run economic pain, may be a better strategy in the long run.

CONFRONTATION OR CO-OPERATION

The United States and Canada differ with respect to international taxation on at least three levels: attitudes, perceptions, and realities. While these three levels are obviously interrelated, we focus here on the basic difference in the Canadian and American positions in these respects.

Canada's traditional *attitude* has been that it is fundamentally a relatively small capital-importing country which must above all fight in international negotiations to maintain its right to tap the profits of foreign investors in Canada and to encourage investment by Canadians in Canada. On the other hand, the United States has seen itself as a major capital exporter which can only gain furthering the international flow of capital. The United States has also to some extent apparently seen itself as the 'tax policeman' of the world, in the sense that it has at times attempted to export its domestic notions of fiscal rectitude to other countries. In short, while Canada's attitude toward international tax negotiations has traditionally been defensive and inward-looking, the United States' attitude has traditionally been offensive and outward-looking.

With respect to 'treaty shopping', for example, while Canadian authorities hardly favour this practice, their general position has been that since Canada is in no position to shape the international rules with respect to multinational investment, their major task is to protect the tax base of Canada rather than to impose any sort of general reform on international capital flows. This attitude is perhaps easier to maintain since Canada has withholding taxes of 10 per cent or 15 per cent on almost every financial flow out of the country anyway, so there is very little potential for foreigners to play games with Canadian treaties.

The position in the United States, on the other hand, appears to reflect both an American tendency to try to impose their view of the world on the world rather than to conform to the world's view of itself and the existence of withholding rates in the U.S. that range from 0 per cent to 30 per cent. Rather than face the domestic political problem of reducing the basic 30 per cent withholding rate on international income flows – particularly after the recent failure to impose a much lower withholding rate on U.S. domestic dividend payments (unfortunately the name is the same although the game is quite different) – it may seem easier to tackle the rest of the world.

As noted earlier, part of the problem in dealing with treaty shopping is clearly that in a world of more than two countries, two countries alone cannot arrive at an agreement that deals with all the possible problems arising from third party developments. The only way to do this would be by a set of matching and reciprocal bilateral treaties between all relevant parties, or even better, a multilateral tax convention. The attempt to develop such a treaty under the auspices of the OECD thus has a great deal of merit, and it is unfortunate that in the end the model treaty was so heavily influenced by the interests of the capital-exporting countries that countries such as Canada, which have traditionally considered themselves to be primarily capital importers, felt unable to fully accept this convention as a basis for negotiations. Perhaps the somewhat changed reality of transborder capital flows between the U.S. and Canada in recent years may in the end lead to the development of a more generally acceptable and truly multilateral approach to this area – though, as already mentioned, it is hard to see any real, long-term solution short of an international tax authority.

In terms of the second level mentioned above, there appears to be a shared *perception* in both countries that measures which favour particular business groups are in the interest of the country. The United States, for example, has through its DISC program attempted to favour American exporters, thus offsetting what it considers to be the disadvantages suffered by this group as a result of certain features of the tax system in other countries. Similarly, Canadian nationalists have long urged increased discrimination in favour of Canadian – that is, against foreign (American) – investors in various industries, particularly natural resource industries. Nationalists thus perceive measures favouring Canadian industry (or at least some of it) as favouring Canada, just as American business groups see measures favouring American business (or some of it) as favouring America. Both countries have therefore spent a lot of time and effort in attempting to offset foreign measures in support of their own interests, and in arguing against other countries' measures in international negotiation.

As might be expected, given the difference in the economic and political weight of the two countries, the United States has been more successful in its efforts than has Canada, although Canada has been surprisingly effective in the tax field in maintaining a degree of favouritism for domestic residents through such measures as its small business deduction and the Canadians-only dividend credit as well as the more publicized National Energy Policy. The stubborn U.S. defence of DISC (and its currently advocated descendant FSC), illustrates the same forces at work in a different political context in that country. The perception in both countries of what is in the national interest – more exports (U.S.), more domestically-owned investment (Canada) – has thus been clearly manifested both in domestic tax policy and in the attitudes to international tax issues discussed above.

On yet another level, however, the *reality* appears to be quite different than the perceptions underlying policy. As mentioned earlier, for example, the United States may well gain through the distortionary taxes on capital that are so often deplored by business – since these taxes affect the U.S. terms of trade favourably – while at the same time it appears to be a net loser through the DISC program, a favourite of business. In Canada, while much less work has been done on these matters, the indications are that Canadians gain less than they think from such measures as the interest withholding tax and have little or nothing to gain from export subsidization.

Canada has in the past, however, probably gained substantially from the export of U.S. capital as a result of such basic U.S. provisions as deferral and the positive Canada/U.S. tax differential while presumably Canada lost from the terms of trade effect of the relatively high level of U.S. corporate tax rates. Therefore, on the trade front, Canada appears likely to benefit – via improved terms of trade – from the recent steady decline of U.S. corporate tax rates and the rise of subsidized U.S. exports. With respect to capital flows, however, the reduction in U.S. tax rates inevitably favours the export of capital *from* Canada, as has indeed been occurring.

Arguments such as these in the end reduce to the basic fact that in the world of international trade and factor flows, the United States remains a price-maker, while Canada is undoubtedly a price-taker. A small country such as Canada is in general well-advised not to attempt to tax international capital flows much, since by doing so it will tend to penalize the less mobile factors in its own country rather than to reap any national (or sector) gain. Since Canada has recently become a substantial net exporter of capital, however, the time is perhaps right for yet another reconsideration of Canada/U.S. tax relations. Although the reality of the basic asymmetry in the position of the two countries has not altered, perhaps another decade of treaty negotiation would lead to quite different conclusions than the recently agreed convention. In particular, since neither Canada nor the United States exists in the world alone, both countries ought to consider much more carefully the desirability of a joint (or even multilateral) approach to international tax negotiations as a whole. Canada/U.S. tax relations must be assessed in the context of the relatively integrated nature of the world capital market. Given this reality, there will inevitably be a tendency for a least common denominator rate of taxation on capital income to come into being as time goes on (Bird 1970). In addition to their possible common interest in this respect, Canada has a strong interest in working with rather than against the U.S. as much as possible in developing compatible approaches to accommodate, rather than to deny, changes in the international economic environment. Finally, since both countries have very similar problems with respect to the international impact of developing divergencies in the tax and subsidy policies of state and provincial governments, there is also considerable scope for fruitful joint discussion on common approaches to this area.

CONCLUDING REMARKS

Carl Shoup (1980) has suggested that many of the interactions between tax systems in different countries might be characterized as either reaction effects or emulation effects. An example of a 'reaction effect' in Canada/U.S. relations is the introduction by Canada of the manufacturing and processing tax credit in reaction to the U.S. DISC system – which was itself, of course, a reaction to the benefits U.S. authorities perceived to be received by some European countries from their territorial income tax systems. Examples of emulation effects are the spread of VAT in the EEC and the investment tax credit in Canada and the United States. The increased international flow of tax information accompanying increased trade and factor flows has influenced the nature of tax discussion in many countries (Bird 1970). In no field has this been more true than in the area of international taxation – an area in which policy which for long was the virtually exclusive preserve of a small and interactive group of experts (mostly lawyers in capital-exporting countries). Between no countries have such international spillovers been stronger than between the U.S. and Canada.

Useful though such reflections may be, however, it seems past time for discussion of international tax relations to put aside the notion that tax policies are designed and implemented by unified central bureaucracies attempting to satisfy clearly identified national social welfare functions.[27] In the real world, however, there are always conflicting interests within each country, and the resolution of these conflicts domestically must be taken into account in shaping the international dimension of policy.

One difference between the United States and Canada in this respect has traditionally been that different interests have been more open and more clearly articulated in the political process in the United States than in Canada. This is especially so in the field of taxation. As recent studies of Canadian tax policy have shown, business interests in the Canadian tax process tend for the most part to be articulated indirectly and without publicity, with the result that it is difficult to trace the players in the Canadian tax game (Good 1980). Recent U.S. international tax policy for the most part appears to reflect the continued longstanding influence of the American business community on American public policy (Bauer, Pool, and Dexter 1963), and the much greater salience of international economic issues in recent years. There is no reason to expect matters to be very different in Canada although the players are fewer and the game more quiet. The various international tax subsidies (and disincentives) which have been created in both countries in recent years are thus simply a subset of the general protectionist trend of current policy, which is itself a sub-species of government intervention in general.

Indeed, from one perspective, the principal role of government in modern politics is as an instrument of cross-subsidization and price discrimination (Migué 1982; Stegemann 1982). There is no reason to exclude international tax policies from the ambit of this statement. When a barrier to international factor or trade flows is erected, it is inevitably attributable at least in part of the domestic political pressures exerted by those who expect to gain in terms of increased rents from the erection of that barrier (see also Hartle 1983). Similarly, when a barrier is demolished or reduced, that fact in itself can be read as an indication of the diminished influence of the group which originally had that barrier imposed, or to rise to power of some new group which gains from its reduction. From this perspective, perhaps the most useful way to approach the analysis of international tax relations is not with the normative tool of economic efficiency which dominates the economic literature but rather with the tool of the new economic theory of politics.

Economists tend often to take economic efficiency to be the overriding criterion in terms of which policy is to be assessed. As conventionally trained economists, we have no intention here of questioning the virtues of economic efficiency, particularly since these virtues are so often grossly underrated these days by the advocates of protection, subsidy, and special interest whose voice is now heard so loudly throughout both lands. In the international area, however, as most spheres of life, focusing on efficiency alone affords little help in understanding what is done, or not done, in the real world of the politics of economic policy. From this perspective, international tax relations may probably best be analyzed within the framework of a general theory of government regulation as the outcome of conflicting private interests. This approach has sometimes been disparagingly labelled 'pocketbook politics'. But since taxation is, after all, in the end about whose pocket is picked for how much, it seems likely that the answers to be found by pursuing this approach in the tax field will prove to be more illuminating than yet another exposition of the virtues of capital-export neutrality from the point of view of 'world efficiency'.

When considered in this light, what is perhaps most surprising is not that there are so many complex, contradictory and unresolved issues in the field of international taxation, but rather that there is still such an apparently high degree of economic rationality underlying at least some key characteristics of the international tax system. Perhaps, however, this happy state of affairs reflects not so much the triumph of rationality over interest as the relative unimportance of international taxation in the period during which current policies were formulated. If so, both the greater salience of international fiscal relations in recent years and the apparently increasing acerbity of international economic relations in general – not least between the U.S. and Canada, where the days of the 'special relationship' (if there ever was one) are clearly past – suggest that the future may be quite different than the present as both domestic and international tax systems will more and more be shaped to accommodate the clamour for protectionist policies of one sort or another. Since in our view both countries, but especially Canada, will lose from this trend, we can only hope this prognosis will prove to be too pessimistic and that the case sketched briefly earlier on the virtues of increased international co-operation may prove persuasive.

NOTES

1 Although there were amending conventions in 1950, 1956, and 1966, the basic treaty framework remains that established in 1942.

2 For a recent review of Canada's international investment position, with emphasis on tax factors, see Brean (1984a).

3 The U.S. position is far from being accepted by everyone – see, for example, Bird (1975); OECD (1977, 100-1) – but that is not the place to pursue this abstruse (though important!) controversy.

4 R. Alan Short, in *Report of Proceedings of the 32nd Tax Conference* (Toronto: Canadian Tax Foundation 1981), 412.

5 This observation may appear to lend some support to the common practice of the U.S. courts in turning to legislative history in interpreting tax laws, including treaties. One trouble with this practice, however, is, as Roberts (1982) notes, that U.S. courts understandably look only at *U.S.* legislative history, thus ignoring completely the essence of a treaty as a *bilateral* agreement.

Other aspects of treaty interpretation are discussed briefly later in the present paper.

6 As Alan Short said (in the comment cited in note 4 above) 'Canada is a country which on Mondays, Wednesdays, and Fridays is very concerned with the degree of foreign ownership and on Tuesdays and Thursdays welcomes the amount of foreign investment we need'.

7 Such a tax is the counterpart, on capital account, of the more familiar optimal tariff. See Kemp (1962) and Hamada (1966).

8 For example, the current U.S.-Netherlands Antilles treaty discussions may leave the Eurobond window open for *American* investors while closing the door to third-country 'treaty shoppers' – including Canadian parents financing identical U.S. investments through the Eurobond market.

9 This Act is not intended to affect the interpretation of terms that are fully defined in a convention. It pertains only to those words or expressions that are not fully defined or where the convention itself provides that the meaning of a term is to be determined, at least in part, by reference to domestic legislation.

10 See comments by H.D. Rosenbloom and R.A. Short in *Report of Proceedings of the 32nd Tax Conference* (Toronto: Canadian Tax Foundation 1981), 404-5. This legislation, which came about in response to domestic complaints about what was (by Canadian standards) a small amount of foreign investment in U.S. real estate, provides an interesting parallel to some recent Canadian legislation (e.g., the National Energy Program) also aimed at dealing with a (much greater) foreign involvement 'problem'. The contrasting attitudes of the two countries to their respective attempts to assert sovereignty and satisfy perceived domestic political needs perhaps suggests both that in international tax affairs, as elsewhere, what matters is whose ox is gored and also that, as might be expected, the U.S. is a lot more important to Canada than Canada is to the U.S.

11 In other federations – West Germany, Australia, even Switzerland – all international tax questions are explicitly the province of the national government: see (for example) Duss and Bird (1979) on Switzerland.

12 Unsurprisingly, however, in view of the traditional direction of capital flows, it appears that the stronger hand on such matters is held by the U.S., with the result that even commentators who are strongly critical of such concessions to the U.S. such as the lower dividend withholding tax have suggested that host governments will increasingly have to 'change their tax laws to conform to the

new [U.S.] guidelines' unless they want to erect significant barriers to U.S. investment (Deutsch and Jenkins 1982, 233).

13 The U.K.-U.S. treaty, which was concluded while the Canada-U.S. negotiations were in process, did attempt to deal with this matter, in the end producing an article which was satisfactory to both parties (and which would have prohibited application of the unitary method to a U.K. parent corporation), but this provision subsequently had to be removed to satisfy U.S. domestic political needs before the treaty could be ratified.

14 This position was in effect confirmed in December 1983 and January 1984 Supreme Court rulings on suits by Shell and Alcan. Alcan apparently intends to petition for another hearing on a related case in Oregon on the ground that there are significant differences in the decisions of the relevant circuits of the Court of Appeals (*Globe and Mail*, January 10, 1984, B6).

15 A review of the 1977 OECD model treaty indicates that at least 21 of the 24 member countries entered a total of almost 130 reservations to its 30 Articles – with the U.S. and Canada leading the list with over a dozen reservations each.

It is somewhat ironic that apparently the only real multilateral tax convention which has ever been signed is by the Comecon countries (Biehl 1982, 204). Of course, given the controlled nature of trade and capital flows amongst the Comecon countries, the significance of such a treaty is close to zero (Bird 1964).

16 Given the much greater importance of U.S. developments to Canada than vice versa, it is a bit surprising that apparently no special effort is made in Ottawa to keep up with U.S. tax developments. It is true that it is hard in Canada to avoid being swamped with American information in any case; but this is not the same as a careful, systematic review and evaluation of U.S. tax developments with an eye to their implications for Canada. What the U.S. does is too important for what Canada can or should do to be left largely to chance and personal interests and contacts as now seem to be the case.

17 We do not review here such well-known arguments as those on GATT rules for border tax adjustments and the trade effects of value-added vs. corporate income taxes, however, both because we think these matters have been discussed more than adequately elsewhere – including, at times, by us (Brean 1983a; Krauss and Bird 1971) – and because we do not consider them to be high on the list of 'current' issues with which this conference is presumably concerned.

18 The U.S. insistence on the 'improper' nature of such subsidization may perhaps be related to the traditional American position on 'tax sparing' – the term used to denote a practice (much sought by some developing countries) under which if a host country grants a tax incentive to a firm, the residence country treats the profits of that firm for purposes of crediting tax as if it had been subject to host country tax. The United States has argued against this practice largely on the ground that tax incentives do not do any good anyway and that it is not in the interest of developing countries to give such incentives. (Actually, the American use of an overall rather than per country limitation for the foreign tax credit as well as the opportunities open to international firms to move money about in many different ways made this debate of more theoretical than practical importance for many firms – but it is the principle that is at issue here.)

In sharp contrast to its long-standing concern that the tax policies of other countries should be 'sensible' in this respect, however, the United States' attitude with respect to integration of corporate and personal taxes has generally been, in the name of the principle of nondiscrimination, that the source country should treat residents and nonresidents equally, that is, that nonresidents should get the same imputation credits as residents. To quote a U.S. Treasury official: 'The fact that it [the tax credit] may end up in the coffers of the other country's treasurer, rather than in the shareholder's pocket, is a choice properly left to the resident's country' (Carlson 1980, 19). When the shoe is on the other foot, it appears, the United States has no difficulty in reversing its argument.

The point of this comment is *not* that the U.S. is in any way hypocritical: it is rather that statements of principle can never be realistically considered in isolation from the position of those who make them. It is, in the end, not the *rules* that matter for most purposes as much as the *results* of applying those rules in particular circumstances – circumstances that are in the real world, if not in the world of legal theory, generally known to those who propose the rules in the first place.

19 As noted later, whether or not the U.S. actually gains from DISC – or Canada from its offsetting credit – is quite another matter.

20 Actually, in the early 1960s for a brief period Canada had a program which in effect worked like this – though not very successfully (see Bird 1965).

21 With respect to the first (DISC-like) proposal, for example, Gordon (1982) says that if the U.S. complains Canada should simply enact

'punitive legislation' similar to that in the U.S. While it is not wholly clear to what legislation he is referring, this comment neglects completely the inevitable basic asymmetry in Canada/U.S. economic relations. If matters degenerate to a battle of offsetting 'punitive legislation', it is not hard to see who will win. This is not to say that Canada must passively accept whatever the U.S. chooses to do, but it does suggest that the 'eye for an eye' spirit of Gordon's proposal is not likely to prove a useful approach to bilateral negotiations for Canada (except perhaps as a bargaining counter).

22 Interestingly, this analysis is cited approvingly in the most recent U.S. Treasury (1983) annual report on the DISC program. (The Treasury has never been very fond of this program in any case – or so an examination of these annual reports suggests.)

23 A recent paper by Thirsk (1983) suggests that there may indeed by be some welfare gain to Canada also from the existence of distortionary taxes on capital (see also Boadway and Treddenick 1978), but these results depend primarily upon the fact that such taxes are higher in the U.S. (Murray 1982). Canada can thus in effect reap part of the U.S. gain from such taxes partly through similar terms of trade effects and partly through the way the U.S. foreign tax credit system enables Canada to levy taxes on U.S. controlled firms at the expense of the U.S. treasury. The major lesson of the Thirsk analysis for Canadian policymakers is thus in the end not very different from that in the quite different analysis in Deutsch and Jenkins (1982) – namely, that to a limited extent Canada may have some room to gain through *increasing* taxes on U.S.-controlled firms, so long as the credits generated by the increased taxes remain usable. Of course, such advice must be considered carefully within the reality of the continued international bargaining context and in particular the importance – especially for Canada – of avoiding explicitly discriminatory measures.

24 Although Doran (1983) suggests that Canada's traditional concern that commercial interdependence threatens its cultural autonomy is largely unsubstantiated, he nowhere distinguishes goods and services and uses some very weak and partial measures of cultural autonomy.

25 See, for example, Hartland-Thunberg and Crawford (1982).

26 Sato and Bird (1975) similarly argued for what they called 'effective reciprocity' in place of the 'nominal reciprocity' of the OECD model tax treaty. Their concern however, was to look beyond withholding taxes to the underlying corporate and

personal tax rate structures. The present comment is concerned more with the equitable division of international tax base when inter-country income flows are unbalanced and thus has more in common with the discussion in Musgrave and Musgrave (1972).

27 Most discussion of these matters appears to follow what Allison (1971) has called the 'single rational actor' approach to policy evaluation: for a particularly useful critique of this approach to Canadian public policy, see Hartle (1979).

28 An example of the sort of analysis that seems needed in this field is Gillespie (1983); see also Peacock (1981) and Hettich and Winer (1981).

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Comments

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The interaction of two economies as closely linked as those of Canada and the United States naturally makes it necessary to understand as fully as possible the nature of the most important factors that play important interactive roles. Obviously trade and investment are two such factors. Both trade and investment flows between Canada and the United States are determined primarily by market forces in both countries, of course, but as we know, the policies of government also play a role. Taxation can be a tool of government policy and in fact has been used by both the Canadian and American governments to influence both trade and investment in ways that affect economic relations between the two countries.

For their paper, Richard Bird and Donald Brean chose three subjects for examination: the Canada/U.S. tax treaty; the unitary tax as employed by states and provinces; and subsidies and trade (the U.S. export incentive DISC – the Domestic International Sales Corporation law). I will briefly discuss each of these subjects, giving the DISC primary attention. But first, I will make a few general observations.

Bird and Brean approach their subject in a direct fashion and quite avowedly from the Canadian point of view. This is no 'on the one hand, on the other hand' presentation. Pursuit of Canadian national interest is sufficient justification for discriminatory and higher taxes on dividends, interest, and royalties paid to foreigners than tax on comparable items of income paid to Canadian nationals, notwithstanding an OECD tax-investment agreement endorsing the principle of equality of treatment. The unitary tax at the subnational level (state and provincial), on the other hand, is seen as a commonly shared problem since both the states and provinces can be expected to wish to expand their revenue base at the expense of some other taxing jurisdiction. Treatment of the DISC export incentive does not go much beyond labeling the DISC as an unjustified and illegal export subsidy, even though it is acknowledged that Canada has offset its effects by the manufacturing and processing credit.

Two other general observations may in order. First, Bird and Brean do not attempt to quantify, even by reference to secondary sources, the investment or trade effects of the tax treaty or the DISC. So, we are never quite sure whether the authors are commenting on big investment distortions owing to differential tax treatment by Canada and the U.S., or whether the comments are based on equity, tax-base considerations, or abstract principle. In the case of DISC we have no order of magnitude of trade diversion due to DISC, although we are told that the effect of DISC has been offset by Canadian government tax action that is not in the nature of an export subsidy. Second, Bird and Brean deal with investment and trade as if they were quite independent of each other. U.S. government policy regarding foreign investment and trade assumes that they are interrelated and that to some extent one substitutes for the other or that one enhances the other, i.e., trade leads to investment or that investment lead to trade.

Canada/U.S. tax treaty

The long delay in enactment by the United States of the tax treaty is deplored but not explained. Is the delay occasioned entirely by slow U.S. action due to U.S. constitutional provisions for ratification by the Senate after negotiation by the U.S. Treasury on behalf of the Executive Branch? Or, is at least some of the delay due to changed perceptions of Canadian national interest, i.e., as a result of Canada's choice *not* to press very hard for early enactment after the initial enthusiasm for the treaty had waned following completion of negotiation? And bear in mind that from the American historical standpoint, three or four years is not an unusually long time for the Senate to act on a tax treaty in any case.

The most interesting development in the eleven-year period since the beginning of negotiation of the treaty is the change in Canada's status as a capital importing country. Canada's traditional interests as a capital importer and its desire to strengthen domestic ownership are presumed to continue through the present period even though Canada has become a substantial *net* exporter of capital. Presumably, Canadian capital outflow is mainly to the U.S. although this is not explicitly stated. The question then is why Canadian capital is not more fully engaged in the country's policy goal of 'buying back' Canada's industries, mines, and forests. It is important to know whether this phenomenon is primarily tax related or not, and if not (as I judge to be the case) whether tax instruments are not being overused when general economic policy and further encouragement to private-sector investment (foreign as well as domestic) should be emphasized.

Finally, Bird and Brean open up a very important issue when they refer to the interest of both countries to co-operate to lessen tax avoidance by taxpayers shifting income internationally. They correctly cite 'swollen' Canadian and American investment in tax havens, and conclude that greater attention to this by both countries is in the interest of protection of the home tax base of each country as well as the appropriate course for an open economy in today's world.

Unitary tax

The United States and Canada, both being federal governments in structure, should view taxation by states and provinces in a similar light when addressing the issue from the national standpoint. And indeed, this is the case. Although the need for increased revenue at the state level is certainly critical in many American states, it hardly suits federal authorities and companies that operate in many states and in foreign countries to encourage states to tax income earned in other states and in foreign countries. But that is exactly the consequence of a recent U.S. Supreme Court decision (Container Corporation vs. California Franchise Tax Board). The result of this decision is to do what political subdivisions in no other country are permitted to do – to tax income earned outside their borders. Immediately the effect is to allow California and eleven other states to continue to expand tax collections from the revenue base of other jurisdictions.

Unfortunately, the Canada/U.S. tax treaty does not attempt to deal with this new approach to tax poaching by subnational units of government – the so-called unitary approach. Bird and Brean point out that the traditional approach in dividing the tax base among different jursidictions has been transactional, i.e., based on the characteristics of specific transactions. In the U.S. this concept is known as formula apportionment. Using this concept, states determine the tax liability of companies doing business within their borders by the ratio of economic activity within the state relative to out-of-state respecting property owned, payroll and sales. Apportionment formulae have prior to this time, as a matter of principle, avoided double taxation of worldwide income. The Container case has for the moment changed the rules of game by permitting states to include global income factors in the taxation formula.

It is evident that the unitary tax question is an important one. American multinational companies are not to be taxed on their global income by one state, much less so than by several states. Nor do foreign-owned companies relish the prospect. The UK Prime Minister, Margaret Thatcher, during a visit to the U.S. last September, indicated that 'something will have to be done', that the issue is 'serious', and that retaliatory legislation by the British Parliament may be in prospect.

Is there a constructive approach to the solution of this problem of double taxation in the context of Canada/U.S. tax relationships? I think there may be. It may not be too late to amend the pending tax treaty by prohibiting states from taxing the income of Canadian-owned companies earned outside the territory of the taxing state. Under American law a treaty takes precedence over a state law whose provisions are contrary to the treaty. This approach, if applied equally in Canada, would halt and reverse the unitary tax approach insofar as income of parent companies of the other country is concerned. States would still be free to tax income of American-owned companies on a global basis, however. This latter question could be dealt with by a new congressional law, or by a changed Supreme Court decision.

The possibility of congressional action can be seen in the establishment by President Reagan, on the unanimous advice of his Cabinet Council on Economic Affairs, of a Working Group on Unitary Taxation. The purpose of the group is to study the desirability of reserving to the federal government the power to tax foreign source income.

Finally, it should be noted that the states are not likely to give up the unitary tax approach unless forced to do so. The states are 'starved for revenue' and their plight has not been lessened by cutbacks in federal revenue grants. Tax-shopping among states may already be under way. One major American corporation has already moved its corporate headquarters from California, citing unitary taxation as a major reason for that decision.

Subsidies and trade

The subject of export subsidies through the tax system is a major one in trade regulation and has a long history antedating the General Agreement on Tariffs and Trade (GATT) which dates from 1947. The general principle of the GATT is that export subsidies are prohibited (except for raw materials, as well as more generally on the part of developing countries), if such subsidies cause injury in the importing country. The officially sanctioned remedy under GATT for dealing with an export subsidy is a countervailing duty equal to the amount of the subsidy. This rule has been elaborated and extended as a result of the Code on Subsidies and Countervailing Duties adopted by the GATT in 1979. One major result of the new code is to treat domestic subsidies for the purpose of countervailing as if they were direct export subsidies if the domestic subsidy harms the trading interests of another GATT member country.

Bird and Brean seem to accept that an export subsidy in fact does result when a major tax incentive investment is given and the product of the new plant is intended primarily for export. But they do *not* accept that this is a correct result in the case of a Canadian tax subsidy since 'the system is obviously heavily biased against countries with a smaller domestic market such as Canada ... ' However, instead of developing their case on its merits, they choose to argue that the U.S. (Why not the GATT code, which incidentally was signed by Canada?) has poor standing to argue against subsidies affecting trade because the U.S. has adopted its own export subsidy, the DISC – the Domestic International Sales Corporation.

Is it quite so obvious that the DISC is an illegal export subsidy under GATT? Perhaps the point need not be pursued since the U.S. government has chosen to accept a GATT council finding that the DISC is an illegal export subsidy. Further, the U.S. has decided to convert the DISC into a Foreign Sales Corporation (FSC) and explicitly employ the rationale of the GATT council in upholding the validity of the so-called territorial principle of income taxation in deciding in favour of France and the Benelux countries in export subsidy cases decided at the same time as the DISC case.

Rather than argue the legality of the DISC from the standpoint of the GATT, it might be more fruitful to look at the economics behind the DISC in relation to the GATT rules. First, no country is obligated to tax exports at a higher rate than domestic transactions or imports. In point of practice, most countries, including Canada, choose to tax exports at a lower rate and imports at a higher rate. This result is achieved, in a form quite consistent with the GATT, which authorizes nonpayment of domestic excise taxes on exports but permits domestic excise to be applied to imports. The usual form around the world these days is the Value Added Tax (VAT) in Europe (averaging 15 to 18 per cent), the commodity tax in Japan (some very low and some very high rates, e.g., up to 22.5 per cent on automobiles), and the federal manufacturers excise tax in Canada (nine per cent). The United States has no comparable tax at the federal level. Therefore, manufactured goods exported from the U.S. carry the full social cost of taxation, whereas competing export goods manufactured in Europe, Canada, and Japan may be priced without the cost of VAT or excise added to price. Why not call this a tax subsidy? Answer: the GATT permits it.

Second, the GATT accepts that countries need not tax export profits except on that portion of the profit earned within the country. Thus, as embodied in the territorial principle of taxation employed in France and many other countries (but not Canada), income earned by economic activity outside its borders need not be taxed. The DISC is one method to achieve the tax result inherent in the GATT-approved territorial concept. The DISC accomplishes this result through safe-haven rules designed to place maximum limits on the amount of income that may be attributed to foreign-source income associated with exports. GATT has accepted the concept of arms-length pricing to achieve this result.

The foreign Sales Corporation (FSC) proposal of the American administration now before Congress is designed to follow the GATT rules to the letter by

– making the domestic corporation into a foreign corporation with a factual, palpable foreign presence;

- employing precise rules to determine maximum amounts of foreign-source income that can be attributed to the FSC;
- specifying arms-length rules to determine the maximum allocation of profit to foreign activities as distinguished from domestic value added;
- eliminating the tax liability on foreign-source income rather than simply deferring the tax as under the DISC.

Table 1 below gives some indication of the importance of the territorial tax issue to U.S. industry engaged in exporting. It does *not* deal with the additional price distortion against U.S. competitiveness occasioned by VAT, the Japanese commodity tax or the Canadian manufacturers excise tax. The competitive disadvantage, of course, applies to goods entering the U.S. market and not just the home producing market and third country markets.

The U.S. and Canada have the largest bilateral trade flows of any two countries in the world. Would it not be a good idea to study the trade distorting impact of tax policies of the two countries that unnecessarily provide competitive advantage to other countries in U.S. and Canadian markets? The territorial tax approach is the first candidate for study and the differential rates on excise taxes that may be remitted at the border is the second. These are big-ticket items and both Canada and the U.S. have some potential mutual gains from joint study and possible tax policy changes.

Future work

The subject of tax policy in the context of Canada-U.S. economic relations is an important one, and no doubt will be even more important in the future. Bird and Brean have provided a useful and informative introduction.

For the future, I suggest particular attention to questions in the tax field that are likely to play some role in corporate decision-making respecting the location of new investment and in marketing strategies affecting trade. These topics seem to be appropriate candidates: research and development (R&D) tax credits; regional development tax incentives; industrial sectoral-specific tax incentives; severance taxes (oil and minerals); excise or other taxes affecting trade flows.

It is suggested that the approach to the tax subjects be as policy-oriented as practicable, i.e., reflect analysis of Canadian and Ameri-

TABLE 1
Estimated effective rates of taxation on domestic and export income (%)

	Domestic income	Export income
United States	36.7	27.4
West Germany	39.7	39.7
France	34.3	8.7
United Kingdom	17.8	12.2
Japan	29.2	17.9

SOURCE: National Planning Association (1977) 'Income taxation and competitiveness in the U.S., West Germany, France, the U.K., and Japan'. The above table does not take into account VAT or comparable excise taxes.

can national interests in the broadest sense. Tax harmonization may be desirable in certain instances regardless of marginal advantages to one country or the other from continued disparate tax treatment. Further, concerted Canadian and American action in the tax field can have a beneficial effect on international opinion as to the way to go in what we continue to believe is a world economy that is still moving on the path toward greater integration.

Subsidy pacts

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INTRODUCTION

Throughout the world, governments offer investment subsidies to entice firms to locate in particular geographic areas; 'bailouts' to encourage firms to maintain plants they would otherwise close; and operating subsidies to ensure that firms engage in particular activities such as R&D or exports. Governments have implemented a wide array of industrial policies to achieve specific development goals (e.g., see Conklin 1983; Doherty, annual). A common instrument of industrial policies is the provision of public money, sometimes through direct grants or subsidized loans, but often through indirect subsidies. The latter may include procurement programs that pay higher than market prices; tax concessions, available only for specific types of activities; funding of government-owned corporations that need not achieve the profit rates necessary in private firms; or provision of inputs at lower than market prices. The visibility and value of subsidies – individually and collectively – appear to be increasing in many countries. Furthermore, with current and projected reductions in tariff barriers, such subsidies will become relatively more important as a trade-determining process. Hence it will not be surprising if international trade negotiations devote more attention to these government subsidies. In particular, discussions of freer trade between Canada and the United States will have to confront the subsidy issue, since the elimination of tariffs increases the vulnerability of a nation to the subsidies provided by its trading partners.

It is tempting to discuss subsidy negotiations in the context of the substantial literature that deals with international tariff agreements. At the outset, it is important to note that subsidies differ from tariffs and that the tariff-reduction literature cannot automatically be applied to the subsidy issue. Differences include the problem of defining and calculating subsidies when government financial assistance can take a myriad of forms, the dissimilar impact on regions within a nation and even on firms within an industry, the role of subnational governments, and the procedures for enforcement. Many such differences arise from the fact that tariffs are product-specific and country-specific and deal with imports, whereas subsidies can be firm-specific, region-specific, project-specific, or activity-specific and can deal with all types of production whether or not they involve imports. Furthermore, subsidies differ in important respects from quotas, which are product-specific, country-specific, and deal with imports.

A central theme of this paper is that if subsidies are implemented to achieve specific objectives, then an intergovernmental pact that limits subsidies may diminish rather than improve the well-being of signatories. Rather, a pact may increase welfare by improving the allocation of investments among regions and industries through a more appropriate pattern of subsidies. The phrase 'free trade' is frequently used in the tariff-reduction literature to describe the elimination of tariffs. In a discussion of intergovernmental subsidy negotiations, 'free trade' is a more ambiguous term. The definition of what should be considered a subsidy is not precise; the size of many subsidies cannot be calculated exactly; and much of the existing literature concerning free trade is not applicable.

This paper examines the economic rationales for offering subsidies in an attempt to determine the appropriate economic objectives of international subsidy negotiations. At the outset, it is important to note that current high levels of unemployment and low rates of productivity growth underlie much of the argument in favour of industrial policies and subsidies. If all political entities were to experience rapid growth and full employment, the economic rationales for subsidies would lose some of their significance. In fact, some observers may oppose subsidies, not because of their concern that subsidies alter international trade, but because they believe in the free adjustment of the economy as the optimal way of attaining efficiency and growth. This paper avoids an evaluation of the success or failure of subsidies and simply examines possible economic rationales for subsidies in order to provide a basis for analysing the economic implications of various types of interjurisdictional subsidy pacts.

An investment by a private firm may provide benefits which cannot be appropriated by the firm but which are significant for others within the political entity where the investment is located. Such benefits which are external to the firm include employment opportunities, the sharing of government costs and the advancement of technology. These are often referred to as *externalities* (e.g., see Saunders 1984). A central argument of this paper is that it is useful to regard such externalities as goods offered by potential investors for sale to governments.[1] An international market exists for these externalities; and the prices governments offer to acquire them are quoted in the form of subsidies. Economists and others have devoted considerable thought to negative externalities such as pollution. In such analyses, the use of fines, special taxes, and regulation is seen as a means of introducing a firm's negative externalities into the firm's investment and production decisions (e.g., see Coase 1960). Such negative externalities are not the focus of this paper except in the following sense: where an investment or production decision results in negative as well as positive externalities, political entities seeking to maximize their welfare should offer a subsidy equal to net externalities. One particularly important type of negative externality results from the impact of a subsidized investment on existing manufacturers. Subsidized investment will expand the supply of a product, and existing manufacturers of that product may consequently suffer reductions in output, employment, and profits. The calculation of net externalities and subsidies should include such negative results.

The paper examines this externality-subsidy market in the following sequence. Many types of subsidies are offered by governments, and so negotiators of a subsidy pact will have to decide upon the definition of subsidies to be dealt with, a problem made more difficult by the ability of signatories to switch their financial assistance to forms that have not been included in the pact. The paper considers why the competition for externalities has intensified and, consequently, why the analysis of this market has grown in importance. The perfectly competitive model for an externality-subsidy market is presented, where a large number of governments compete to obtain the investment and production of a large number of firms. Analysis of such a market structure indicates that a pact which seeks to reduce subsidy levels may actually diminish, rather than increase, the welfare of the signatories. Important characteristics of a subsidy pact in a perfectly competitive market include the ceilings established for subsidies, the provisions for adjusting these ceilings, the relationships with nonsignatories, the degree to which firms can choose to locate in nonpact countries, and the opportunity for signatories to shift their assistance to forms not included in the pact.

The paper then considers the case where perfect competition in the externality-subsidy market fails because there are too few firms, such that a location decision may alter the terms of trade. In such a market, it is suggested that a series of pacts may be necessary, with one for each type of product. The externality-subsidy market may also fail because the information available to governments is imperfect. In such circumstances, it is suggested that a pact for the sharing of information may improve the welfare of all signatories. The competitive model may fail because externalities may spill over into other jurisdictions. In this case, a pact under which subsidies are pooled could rationalize subsidy offers, allocate costs in accordance with externalities, and so make all participants better off than if the investments went elsewhere. The reduction of political barriers can serve as an alternative to subsidy pacts. Finally, the enforcement issue is considered and several concerns are raised, particularly the independence of state and provincial governments and the ability to retaliate against the subsidies of nonsignatories. Throughout the paper, it is suggested that analysis of the externality-subsidy market and the process of negotiating subsidy pacts will rely heavily on studies of specific firms, production processes, groups of unemployed workers, and regional disparities. The techniques of industrial-organization studies including cost-benefit analyses of subsidies will be necessary to place estimates on the various aspects of the externality-subsidy relationships. Sector-by-sector analysis and negotiation seems most appropriate. A set of observations are drawn from these discussions.

Under perfectly competitive conditions, the market for externalities, like any other market, should result in an efficient solution, with investments going to those locations (or staying in those locations) where the internal rate of return, plus subsidies equal to externalities, is greatest.[2] Collusion among political entities could reduce the level of subsidies, but at the same time it could create distortions and inefficiencies. A subsidy pact must find its justification not in the simple objective of reducing subsidy levels, but rather in the desire to overcome specific market failures in the externality-subsidy process. This paper argues that such market failures do exist and that they determine the appropriate features of a subsidy pact.

Many of these issues and analyses are relevant for all levels of government. Within a single nation, municipalities, provinces, and states use subsidies to compete against each other for private investment and production. Concern for an internal common market or economic union may focus on these issues (see Trebilcock et al. 1983). Furthermore, international investment competition may occur not only at a national level but also between subnational governments.

THE PROBLEM OF DEFINING SUBSIDIES FOR THE PURPOSE OF A PACT

Negotiation of a subsidy pact will have to deal with the definition of subsidies; and the definition chosen will affect the nature of the pact. The following examples illustrate this point:

Inclusion of state, provincial, and municipal assistance as subsidies under the pact

A 1982 book by Davenport et al. examines the recent substantial growth of provincial financial assistance. The authors estimate that total provincial direct subsidies grew from an annual level of $1 million in 1970 to $204 million in 1979. Apart from these, provincial governments implement various procurement policies through which domestic companies can receive higher prices than those quoted by foreign companies. Such practices are allowed by many American states. All levels of government provide goods and services at less than market prices in a manner that subsidizes the costs of private firms.

In regard to this aspect of negotiations, a subsidy pact will be quite different from those agreements aimed at tariff reductions. To what extent can a national government control the actions of minor governments within its borders? In both Canada and the United States, it is difficult to imagine effective national government commitments. Will it be possible to include provincial and state governments in negotiations? The mechanics for such involvement would be new for many participants, and the process somewhat unclear. Even the constitutional division of powers entails ambiguities which could become important in such negotiations. A pact that includes subnational governments will likely have to focus initially on a narrow and precise definition of subsidies, with gradual extensions in future agreements to include additional types of government assistance.

Government ownership of corporations

Canada and its provinces have developed a large set of crown corporations, many of which produce and sell significant quantities of goods that are produced and sold by private firms in other countries. Generally, such government operations do not base their prices on the same market criteria followed by private firms, nor do they pay corporate income taxes, as private firms must. In particular, a market rate of return on capital invested is usually not of the same concern in government operations. Government provision of capital to such firms at less than market rates, and government payments to cover operating losses, can form significant subsidies for the products concerned, and these subsidies may distort trade patterns. The energy sector provides examples of this, where Canadian government-owned hydro and oil companies may compete with private U.S. corporations. Aircraft manufacturing may be particularly important in the near future, as government-owned Canadair competes internationally with its Dash-7, a 50-seat commuter aircraft with STOL capacity, its Dash-8, a 36-seat aircraft, and with its new executive jet. The Ontario government's Urban Transportation Development Corporation is actively competing across Canada and in other nations to sell rail passenger vehicles, subway cars, and integrated urban-transit systems. Government marketing agencies may subsidize private domestic producers in a manner that affects international trade. This has particularly been the case with agricultural marketing agencies, and the EEC's common agricultural policy (CAP) has had serious effects on world trade, recently, for example, involving disputes with the U.S. over exports to Egypt and China. For its own part, of course, the U.S. government price-support programs have a major effect on the prices and quantities of traded agricultural products. Government corporations may provide subsidized inputs, such as cheap energy or petrochemicals, that give private firms an advantage in international competition.

Of particular interest are manufacturing firms which initially received explicit subsidies but which later were taken over by government. In Canada, Consolidated Computer Incorporated and Canadair both became government-owned after a period of receiving explicit subsidies. With the change to government ownership, however, calculation of the value of the implicit subsidies becomes much more difficult.

Communist and other nonmarket nations present special difficulties in that a substantial proportion of their prices do not reflect production costs. Implicit subsidies may provide many of their products with special advantages in international competition, and yet it may not be possible to calculate the extent of such subsidies. How such nations could participate in a subsidy pact is a most perplexing issue. Yet to establish subsidy pacts without their involvement, while still permitting trade with them, would jeopardize particular firms within the signatories.

Government provision of goods and services

All levels of government provide goods and services at less than market prices. Many municipalities offer commercial land at subsidized prices, often in specially developed industrial parks. A vast array of government programs reduces the costs of private corporations.

Programs aimed at improving the education and skills of the labour force are unlikely to be subject to subsidy pacts in spite of their importance. Yet many recently instituted programs aimed at stimulating R&D may well be the subject for international negotiation, particularly when these take the form of linkages between government-funded universities, research laboratories, or technology centres on the one hand and private corporations on the other.

Of major significance are the provision of government Capital at interest rates below those prevailing in the market and the provision of government guarantees for corporate loans within the private sector. Most dramatic, perhaps, are government subsidies for the purpose of bailing out firms considered to be in such severe distress that they will close some or all of their operations if not granted financial assistance (Trebilcock et al., forthcoming).

Capital assistance can be directed at many objectives other than bailouts. A 1982 study by the Economic Council of Canada documents dozens of Canadian government programs – both federal and provincial – which provide loans and loan guarantees. This study uses the government bond yield to estimate the amount of subsidy involved in the special interest rates charged for these loans (Economic Council of Canada 1982). To calculate the subsidy component of such assistance and to relate that component to a particular firm at a particular time is extremely difficult and results in imprecise estimates. Even the calculations of the Economic Council as they relate to subsidy estimates by program can be subjected to criticism.

Government tax concessions

Special tax concessions can reduce a private firm's costs and provide a competitive advantage to much the same extent as direct subsidies can. Consequently, it is likely that governments negotiating a subsidy pact will wish to include special tax concessions in such discussions.

On a general level, some countries have relied on a value-added tax which is not payable on exports. In countries that impose corporate income taxes instead of value-added taxes, the argument can be made that foreign competitors' firms are being subsidized by the VAT export rebate programs.

Cultural subsidies

Canadian governments have developed significant subsidy programs to stimulate the growth and refinement of a distinctive culture (e.g., see Lyon and Trebilcock 1982). Some such activities probably reduce the level of Canadian spending on non-Canadian cultural activities. In July, 1983, for example, a new federal government fund of $230 million was established to assist Canadian television production over the next five years. Arrangements are made on the basis of $1 of public money to match every $2 of private money. Together with this explicit subsidy program, the government also introduced additional tax concessions for such private investment (*Globe and Mail*, 1983). No doubt some recognition must be given to a nation's desire to strengthen its cultural identity, and some level and types of subsidies must be permitted for this purpose. What level of such activity and what types of programs exceed reasonable behaviour and so should become the subject for international subsidy negotiations? The issue of tax deductibility of Canadian advertisements in U.S. magazines has shown that such cultural protection can cause bitter reaction and significant retaliation.

Different assistance for foreign versus domestic investors

The exclusion of foreign investors from some of the subsidies offered to domestic investors has created another area of potential conflict that could be the subject of international negotiations. Special assistance to the exploration activities of Canadian-owned oil companies through PIP grants leaves foreign-owned firms at a competitive disadvantage even if their performance within Canada is no different from that of Canadian firms. To qualify as having Canadian content, film productions must fulfill an arbitrary set of nationality requirements in terms of the individuals in such productions. Within any subsidy pact, an important question will be the right of access by foreigners to the subsidies being offered, and the conditions that should govern that access.

COMPETITION FOR EXTERNALITIES: RECENT INTENSIFICATION

Three major investment externalities are those relating to employment, the sharing of governments costs, and the advancement of technology. In recent years, these have grown substantially in importance for a variety of reasons:

- Political entities at all levels have increased their spending for the unemployed. Many government programs cater specifically to the needs of the unemployed. If a potential investor creates a job opening for an unemployed person, this will result in a decrease in government spending that will be equal to a substantial portion of the wage. Hence the linkage has become clearer and more substantial between investment subsidies on the one hand, and decreases in spending on the unemployed, on the other.
- It appears that the nature of unemployment has changed. Many of the unemployed will need to learn new skills in order to work, and

these skills may best be learned in an apprentice type of training within a firm. Without such retraining, many of the unemployed may remain jobless indefinitely. In the past, governments may have viewed unemployment as a cyclical phenomenon, with economic recovery bringing an automatic solution. Today, the perceived investment externality is thus much greater than in former years. Subsidies may be necessary to provide retraining within the business sector since the spending on some members of the unemployed may otherwise continue indefinitely.

– Government expenditures have risen dramatically in recent decades. New investment is often seen as a means of spreading these high government costs over new taxpayers. Recent recession and diminished productivity growth have strengthened this view.

– Many governments have become more responsive to the lobbying of third party individuals who may be affected by an investment decision. In particular, the closing of a plant will hurt employees who, in their own right, will influence a government's decision to provide industrial subsidies.

– 'High tech' has come to be a significant component of productivity growth. New 'high tech' investment can advance the general level of scientific knowledge and skill and can assist other firms and individuals in their adoption of new technology. The Economic Council of Canada has recently published *The Bottom Line: Technology Trade and Income Growth*, which describes current government assistance programs that seek to stimulate R&D, and which advocates extensions and modifications to improve their effectiveness (ECC 1983).

As a result of these trends, the externality-subsidy market has become increasingly active. Hence analysis of this market has grown in importance, particularly in regard to the question of whether unlimited competition among governments will result in efficient location decisions, or whether a pact that limits subsidies might be more appropriate.

THE PERFECTLY COMPETITIVE SOLUTION

A government should be prepared to offer a subsidy up to the present discounted value of the future stream of externalities associated with any investment. To offer less could mean that the firm would locate elsewhere, to the detriment of the local economy. A government should calculate the maximum appropriate subsidy for each potential investment, offering subsidies up to this amount as long as its well-being could be enhanced by more investment. Since a very large number of investment possibilities exist, with a very wide range of sizes, no government is noticeably affected by the subsidy offers of any other government, except insofar as all such offers influence the market price of externalities. A particular externality may not be of the same value to all governments. For example, the social cost of unemployment or the presence of underutilized government services may vary among political entities. Similarly, the projected internal profitability will vary among political regions. Consequently, each firm locates in the particular territory where its combination of externalities, plus its internal profitability, is highest.

A PACT FOR THE SOLE PURPOSE OF REDUCING SUBSIDY LEVELS

Suppose that a subsidy pact provides for a maximum permissible subsidy level. Those governments for whom particular externalities would be worth more than this level will not be able to purchase as much investment or production as they would under the perfectly competitive approach. Overall efficiency is reduced, since nonprice elements will become a determining factor in location decisions. Investments and production will not be drawn to the political territory where they are valued the most. The lower the maximum permissible subsidy level, the greater will be this distortion. Externalities will be of most value to those political territories with the highest rates of unemployment, and so these will be the territories most hurt by such a noncompetition pact.

In recognition of this likelihood, the EEC has established three different subsidy levels to reduce distortions caused by its non-competition subsidy pact:

> In the first, poorest, area the ceiling on aid is set at "75 per cent net grant equivalent of initial investment" or "13,000 EUA (European Units of Account) per job created by the initial investment". In the second group the ceiling is set at 30 per cent net grant equivalent, or 5,000 EUA per job created, provided that the 'job creating' grant does not exceed 40 per

> cent of the initial investment. In the third group the ceiling is set at 25 per cent net grant, or 4,500 EUA per job created, but not to exceed 30 per cent net grant equivalent. For the final group, which comprises the major part of the Community, the ceiling is set at 20 per cent net grant equivalent, or 3,500 EUA per job created, not to exceed 25 per cent of the initial investment (Schwartz 1983, 401).

The EEC approach will only be successful in allocating investment externalities to the extent that these ratios mirror their relative values to each political territory. That regulators will be able to establish price ratios that closely resemble those of a free market seems unlikely. Distortions will probably remain.

Five other issues deserve mention. First, regulators such as those who set the EEC subsidy levels should retain the right to alter these ratios as circumstances change and as distortions become apparent. That is, a noncompetition pact of this type should provide for changes to be made over time, whenever the regulators see that the ratios are, indeed, causing distortions.

Second, the process of establishing such ratios may well involve political tradeoffs and noneconomic elements, and the procedures for establishing these ratios may affect the ratios themselves. In Canada, substantial discussion has focused, in the past, on the impact of tariffs on different regions of the country and the question of the regional beneficiaries of tariff reduction. Such discussion will probably shift its focus to subsidies, and regional political forces will advocate their respective interests in any subsidy pact negotiations.

Third, a pact of this type exposes all of its participants to the risk that nonsignatories will gain the benefits of the pact. Firms with externalities having a free market value higher than the permissible subsidy levels will consider locating in political territories that are not subject to the pact. The participants in the pact will have deprived themselves of a set of potential investments, while for nonpact members the total supply of externalities has increased, thereby decreasing their market price of subsidies.

Fourth, the extent to which such a pact can achieve its objective will depend upon the degree to which firms can locate in nonpact political territories. The post-1945 expansion of international investment suggests that such a pact will become less useful. Firms are increasingly able to shift production facilities to other nations, particularly with recent and projected decreases in tariff barriers.

Fifth, a subsidy pact that deals only with new investment may shift the competitive bidding towards bailout subsidies, as pact members strive more vigorously to retain the investment they already have. The extent to which such bailout competition will intensify will depend upon the degree to which the subsidy pact forces new investment to other nations. Hence, a subsidy pact which firms can evade through international investment will face particularly severe difficulties in terms of bailout competition among the signatories.

A subsidy pact may focus on one particular type of subsidy, such as government export financing. At present, a consensus arrangement exists among twenty-two industrial countries, establishing minimum government interest rates for export financing. The comments above are generally applicable for such agreements. In particular, recent significant changes in interest rates and exchange rates have emphasized the need for flexibility in the provisions of such a subsidy pact. Recent amendments to the OECD pact provide a formula for automatic adjustments in permissible interest rates for export financing. Only experience will be able to tell whether the formula itself will have to be changed over time.

MARKET FAILURE DUE TO TOO FEW FIRMS

The perfectly competitive model presented above will fail if a particular industry has so few members worldwide and such a low elasticity of product substitution that firms in that industry possess market power. Such a situation may rest upon the existence of substantial economies of scale, or the possession of essential technical knowledge. In such a case, the location decision of the firm involves more than the externalities discussed above. By enticing such a firm, a political territory may alter the market structure for the relevant product. In the extreme, a political entity might attempt to monopolize production and alter the international terms of trade. A substantial body of economic literature deals with competitive behaviour when few producers exist, such that decisions of one firm directly affect the welfare of the others. Game theoretic analysis suggests a variety of strategic reactions. Much of this discussion is relevant in considering the use of subsidies by political entities in order to maximize their interests vis-à-vis those of other political entities (see Brander and Spencer 1983).

When such a situation exists, there is no doubt that the subsidy market can deteriorate to a crude level of economic warfare. One might imagine a country monopolizing production of a particular type of aircraft, or some microelectronics or biotechnology product, and then raising the international price. And one might imagine a country offering special subsidies to attain this objective, particularly R&D subsidies.

Such situations can be important, politically as well as economically. Boeing argues, for example, that Airbus Industrie has been subsidized by over $5 billion in 1982 prices. From the perspective of Boeing, these subsidies have created unfair competition. From the perspective of France, these subsidies have prevented a complete reliance on Boeing, with the risk of substantially higher aircraft prices.

Professor Wonnacott has focused on this type of market situation in discussing the question, 'Can comparative advantage be created or engineered?' He refers to 'a broad range of high-tech products that may now be almost equally well produced in the U.S., Europe or Japan'.[3] Technology is now of central importance to many production processes, and economies of scale mean that the first nation to 'target' a particular product for special subsidies and protection may gain a comparative advantage.

Is a subsidy pact of any use in this type of market failure? If so, what type of pact would be most appropriate? A subsidy pact may not be in the interests of the political entity expecting to win, but it may be of substantial benefit to the political entity expecting to lose. An interesting question concerns the ability to predict beforehand what the results of such competition would be, in particular whether a small open economy like Canada would be able to compete effectively or whether the larger nations would consistently be victorious. Furthermore, especially in cases involving R&D subsidies, it is not clear even what subsidy pact could be established that would have an economic rationale. The most that could be hoped for would be a separate pact for each such situation, with the pact subject to revision as circumstances change. The objective of each pact would be to replace the market result with a political result, negotiated between the governments concerned. The uncertainty of the market result, together with its unknown threat of extreme outcomes, would be replaced with a political result, probably based on a compromise.

Three Canadian examples illustrate different aspects of the uncertainty of market results and the role of political involvement when subsidies and trade involve few producers. First, Canadian political leaders must decide whether to join the Airbus Industrie consortium, with an up-front subsidy investment of some $500 million and perhaps the expectation that Air Canada will purchase its airplanes from the consortium (*Economist* 1983, 58). For the United States and Boeing this may be a significant decision, and so they may be prepared to negotiate special concessions for Canada as an alternative to the European connection. The details of such possible concessions, the process of negotiation, and the ultimate outcome cannot be predicted with much certainty.

Second, the Canada/U.S. Defence Production Sharing Agreement provides for trade in defense products to be 'in rough balance'. This agreement which has been in effect for twenty years represents a political compromise concerning trade. The 'rough balance' concept has no apparent basis in comparative production costs. In both nations, defense industries have been given substantial subsidies, and one may regard this agreement as a political means for dealing with the competitive subsidy problem when few producers exist.

Third, when Canadians were recently considering the oil industry megaprojects, Canadian content in the provision of the megaprojects became a political issue. A major concern was that imports not take over too much of the subcontracting. The media discussion at the time and the appointment by the government of a Task Force to provide recommendations concerning megaproject procurement policy illustrated the political nature of this issue.

In cases such as these, economic analysis is limited in its predictive insights; the outcomes have an added element of uncertainty; and political considerations and compromise are important. Special intergovernmental negotiations may be necessary on a case-by-case basis. In the future this will likely be important for aircraft, automobiles, energy, petrochemicals, and defense equipment.

MARKET FAILURE DUE TO IMPERFECT INFORMATION

The economic information on which governments base their decisions is far from perfect. Information necessary for a perfectly competitive externality-subsidy market has several special characteristics, each of which complicates the government's task.

First, much of the relevant information must come from the individual firm requesting the subsidy. This involves the moral hazard problem that the firm has an incentive to present imperfect information in an attempt to maximize its subsidy.

Second, some externalities are particularly difficult to estimate. For example, the extent to which a new investment will be able to bear some of the cost of existing government services will depend upon the investment's profitability – hence its ability to pay taxes – and also upon the extra burden it will place on those government services. Employment estimates may differ substantially from actual employment simply because the investment's success cannot be predicted with a high degree of accuracy. The firm's success will depend upon developments in a wide range of factors, many of which will be beyond the control of the individual firm.

Third, the future stream of net externality benefits must be discounted to calculate their present value, which will be the upper limit of the subsidy to be offered. What is the appropriate rate of discount for this purpose? Economists have encountered substantial difficulties in analysing this issue, and no particular discount rate can avoid criticism.

Faced with these imperfections in information, one may conclude that the calculation of subsidy offers is subject to a substantial margin of error. From this perspective, a subsidy pact could be helpful if it sought to improve the quality of information on which political entities base their subsidy calculations. That is, participants could agree to collude in the sharing of information while agreeing to maintain competition in the offering of subsidies.

Such an information-sharing pact might improve the welfare of all participants, for two reasons. First, when a government quotes an erroneously high subsidy and thereby acquires a particular investment, the government for whom the benefits would be greatest must experience a welfare loss. The existence of a large number of other potential investments may mean that any such loss will be small. Nevertheless, if a large proportion of subsidy offers is erroneously high, one might expect a major deterioration in the market. On the other hand, a consistent underpricing of subsidies would also result in market distortions. In the latter case, the wise bidder would gain from, rather than be hurt by, the errors of other governments, since it would pay lower subsidies than otherwise. Consequently, a participant that was confident of its relative wisdom might eschew a pact. Apart from this possibility, an information-sharing pact could reduce the number and extent of erroneous calculations and, hence, could improve all participants' positions.

The second reason why an information-sharing pact might improve the welfare of all participants is that the process of exchanging information could lead to an improvement in the quality of that information. Ideally, such an exchange would provide for discussions of differences in the calculations among governments. Even the discussion of previous subsidy experiences could improve the process of analysing such information. Faced with more accurate information, all participants would be able to reduce errors in their subsidy offers, and so all might gain as a result of such a pact.

Such information sharing seems to occur regularly within nations as different levels of government participate together in providing financial assistance. However, among nations, this process seems to be at a preliminary stage. The GATT Tokyo Round Code on Subsidies and Countervailing Duties provides a structure for the examination of complaints and the resolution of disputes which may, over time, serve the purposes of an information-sharing pact. The informal understandings among its signatories also provide for negotiations prior to the appeal to the formal GATT structure. For example, the 1982 U.S.-EEC steel pricing dispute was settled directly by the parties involved (see Mueller and van der Ven 1982). Conflict resolution may be a useful forum for information sharing, but more efficient arrangements can be envisaged. In regard to the U.S. and Canada, Rodney Grey has expressed the view that 'One proposal of the highest priority is the need to develop the habit of Canada and the U.S. consulting about subsidy policy' (Grey 1982a, 453).

MARKET FAILURE DUE TO SPILLOVER EFFECTS

The perfectly competitive solution rests upon the assumption that, for each potential investment, all externalities can be captured by individuals, firms and the government within the political area in which the investment locates. In fact, however, externalities may accrue to individuals and firms outside the political region. In such cases, government will not be prepared to offer a subsidy equal to the investment's externalities, but only a subsidy equal to the portion of externalities captured by its residents.

Net positive spillovers

In such circumstances, governments may improve upon the perfectly competitive solution through a subsidy pact that results in jointly-funded subsidy offers, larger than any one government could propose. That is, governments may recognize the spillover effects of an investment, realize that more than one political entity can gain from the investment, and calculate a sharing of subsidy costs in accordance with the expected division of externalities. Effectively, this process occurs within a nation when subordinate levels of government surrender the right to grant subsidies to a higher level of government. The latter can raise revenue across all subordinate political entities and grant a subsidy which may benefit all the subordinates.

To minimize administrative costs, governments may enter a subsidy pact of this type for all potential investments. Subordinate governments may surrender their right to grant subsidies. Their willingness to enter such a pact will depend upon the confidence they have that the senior government will perform subsidy calculations and will raise revenue in an efficient and equitable manner. Their willingness will also depend upon the strength of their common interests – the degree to which they regard each other's success as being interdependent – and the ability of their residents to migrate or otherwise share in any exceptional winnings of the others.

Not surprisingly, political entities have been reluctant to enter a permanent, all-inclusive subsidy pact of this type. American states and Canadian provinces have avoided such a pact, as have the EEC nations. Nevertheless, it is possible that such a pact may be in potential signatories' best interests for a particular range of investments. For example, it is conceivable that EEC countries will develop joint subsidy proposals in order to ensure that a particular investment will occur in Western Europe. At the present time, these nations are considering the joint funding of a $1.5 billion research program, called Esprit, for semiconductor and computer technologies (*Business Week* 1983, 45). It may even be in the interests of subnational governments to develop single-industry pacts. Michigan, Ohio, and Ontario are so intimately linked in terms of the automobile industry that new automobile investments in any one of the three may provide some benefits to the other two. In such a case, a pact to rationalize subsidy offers and allocate costs in accordance with externalities could make all participants better off than if the investments went elsewhere. The Chrysler bailout situation illustrated this interdependence, as both Canada and the U.S. stood to lose if Chrysler failed and so both were prepared to offer assistance. Explicit recognition of this interdependence could improve the overall allocation of subsidies.

Net negative spillovers

Subsidized investment will expand the supply of a product, and existing manufacturers of that product may consequently suffer reductions in output, employment, and profits. While a government should include these negative externalities in its subsidy calculations, it may omit them to the extent that existing manufacturers are located in another political entity. A pact may obligate its signatories to consider such effects in its subsidy calculations. This is a central purpose of recent GATT agreements concerning subsidies.

Negative spillovers can take three distinct forms. Foreign firms may find their sales hurt in their own country, since the subsidized firm can export at a lower cost than otherwise. Foreign firms may find their own export sales hurt as they compete abroad against subsidized products. Foreigners may be discouraged from undertaking new investments or making new products if they know that the subsidies will put them at a competitive disadvantage. While the last two forms of negative spillovers may be extremely important, it is the first form that has generally elicited most response. The GATT provisions seek to guard against all three forms of negative spillovers, but, since formal complaints are required to start GATT procedures, foreign firms finding their sales hurt in their own country will remain the principal focus of concern. The need to demonstrate 'material injury' in order to impose countervailing duties will also tend to focus on such domestic sales where the injury can be seen most clearly.

REDUCTION OF POLITICAL BARRIERS AS AN ALTERNATIVE TO SUBSIDY PACTS

The analysis of this paper has rested upon the existence of discrete political entities. Each government seeks to maximize the well-being of its particular individuals and firms, and an important instrument is the ability to attract new investment through subsidy offers. Pacts have been shown to be capable, in some circumstances, of increasing the welfare of all signatories. It should be noted that the reduction of political barriers can serve as an alternative to subsidy pacts.

In the extreme, if two separate political entities decide to merge, then the new government can examine investment potentials throughout the two areas and can allocate subsidies in the same pattern as could be achieved through the pacts discussed above. The reduction of political barriers can also improve efficiency through facilitation of labour and capital mobility and the reduction of tariffs. In such a process, a high unemployment area may experience emigration. Consequently, the externalities that investment can provide may be diminished and the optimal subsidies for investment in such an area may decrease.

ENFORCEMENT MECHANISMS

A discussion of enforcement of subsidy pact provisions crystallizes the ambiguities and complexities of this subject. It is not likely that state, provincial, and local governments can be prosecuted before international judicial bodies. The place of such governments in international agreements and enforcement bodies has not yet been clarified. Definitions of subsidies are necessary for compliance and essential for enforcement. Yet such definitions will not be developed easily. A wide array of government activities can act as substitutes within the subsidy field, and the prohibition of a few specific types of subsidies may well lead to a shift to the use of other types of subsidies. Furthermore, many programs such as those assisting R&D can be tailored so that in practice they benefit only one, or a few, firms.

An injured nation may have difficulty in retaliating directly against a violator of the pact without at the same time punishing all the signatories. A recent illustration of this type of problem was the 1983 U.S. restriction of specialty steel imports in retaliation against EEC subsidies. As noted by Robert Stern, in his paper for this conference, 'Canada may be affected adversely even though its exports are not subsidized'. This situation, which Stern has called the 'innocent bystander' problem, is likely to occur regularly in the enforcement of subsidy pacts. Conceivably, a Canada/U.S. subsidy pact might preclude U.S. action of this type.

The U.S. Trade Agreements Act of 1979 rests upon a 'material injury' requirement. As such, it relies upon complaints by U.S. firms; and it provides for the U.S. imposition of countervailing duties if such injury is proven. Rodney Grey has referred to these types of provisions as 'a system' and has described 'the increasing legalization of trade relations,' (Grey 1982b, 8) caused by this reliance upon contingency protection.

In this process of enforcement and regulation, interesting questions will arise concerning the effectiveness of one's ability to retaliate if injured. Important to this will be the nature and extent of one's relations with the violating government. For example, Canada's ability to enforce a pact will be much less than that of the United States. Small signatories will have to rely on joint retaliation or upon the goodwill of larger members.

Political elements will no doubt enter the enforcement and dispute-resolution mechanisms. This tendency has been illustrated in the U.S.-EEC 1982 steel subsidies conflict:

> The Reagan Administration had repeatedly voiced its resolve to stay out of the conflict and not to interfere with the steel industry's efforts to seek relief under the laws of the land from alleged unfair competition. This resolve did not endure, however. What had begun as private legal action turned into a bitter international dispute and, also, as on previous occasions, high-level government officials soon found themselves engaging in 'shuttle diplomacy'. (Mueller and van der Ven 1982, 262)

The Ontario Ministry of Industry and Trade has published its position on these enforcement issues in a document entitled *Canadian Trade Policy for the 1980s: An Ontario Perspective.* The following quotation is significant not only as an indication of Ontario's views but also as an insightful commentary on the shortcomings of the existing GATT procedures:

> The various concepts of injury both in relation to unfair trade practices, as in the Antidumping and Countervailing Codes, and to disruptive trade, as in the Safeguards Code, have never been defined to GATT signatories. It is, therefore, left primarily to domestic legislation and practice to give interpret

ation of these key concepts. In a number of countries, moreover, national legislation is not sufficiently consistent with the GATT codes, thus creating disparities between levels of import protection afforded to domestic industry in different countries.

In order to encourage consistent, multilaterally accepted interpretations of key GATT terms and concepts and to ensure that these emerge by way of negotiation and agreement between signatories, rather than primarily by the weight of U.S. practice, Canada should be seeking further clarification of these codes at the multilateral level. With such a dependence on exports, Canada has a particular interest in ensuring that the threshold of pain, the criteria for material, serious and regional injury and the required causal link between imports and injury are not overly loose. Ontario, therefore, recommends that:

– agreement be sought to review and clarify definitions of injury in existing GATT codes with a view to laying the basis for more consistent multilateral interpretations of these codes.

The ability of the GATT system to establish appropriate mechanisms and procedures for dispute settlement between signatories is a central element of the system and the basis of much of its legitimacy and credibility. This credibility is undermined if dispute settlement procedures are not adhered to and results of these procedures not respected. Ontario, therefore, recommends that:

– Canada commit itself to "support and respect the results that emerge from the GATT dispute settlement procedures" and firmly encourage similar adherence by other signatories, such as the United States, which continues to try to negotiate out of having to accept the fact that DISC is a breach of its GATT most-favoured-nation obligations.

Canada should also come forward with some constructive criticism of GATT dispute settlement mechanisms (notifications, consultation, surveillance, dispute settlement) with a view to encouraging "review and improvement" of certain aspects of the mechanisms. This would include proposals for examination of such issues as delays in adopting terms of reference of panels, delays in forming panels, time limits and enforcement of decisions.

OBSERVATIONS

A series of observations can be made concerning intergovernmental subsidy negotiations:

- The subsidy negotiations will be extremely complex, more so than traditional tariff negotiations. In particular, they will have to deal with problems of definition and with the ability of signatories to switch their financial assistance to forms that have not been prohibited, and they will have to cope with novel enforcement problems.

- Simple agreements to reduce the levels of subsidies may conceivably reduce the welfare of the signatories.

- Sharing information in regard to the subsidy-investment-externality process may reduce errors in estimation and, consequently, may improve the well-being of all participants.

- An optimal subsidy pact will likely involve a set of pacts, some dealing with specific types of subsidies, and some dealing with specific firms. In particular, subsidies to firms possessing market power and considering large investment or production decisions may require special intergovernmental negotiations on a case-by-case basis. This will likely be true for aircraft, automobiles, energy, petrochemicals, and defense equipment.

- An optimal set of pacts will have to provide for review and adjustments to its provisions on a frequent or continual basis. A permanent structure for such review may deserve consideration.

- In negotiations, all levels of government will have to be involved. This contrasts in fundamental ways with traditional tariff negotiations, which have involved only national governments.

- Negotiations will have to consider the impact of a subsidy pact on trade with nonsignatories. Pursuant to tariff negotiations, concessions can be extended to other governments whenever the latter chose to participate in the agreements. With a subsidy pact, nonsignatories may automatically benefit from signatories' reductions of subsidies without themselves providing any concessions. This factor alone is a sufficient condition to necessitate review and flexibility within a subsidy pact, as experiences accumulate and as circumstances change.

– Externalities may spill over into other jurisdictions. In this case, a pact to pool subsidies and rationalize subsidy offers could make all participants better off than if the investments went elsewhere.

– Reductions of political barriers can serve as an alternative to subsidy pacts.

– Analysis of the externality-subsidy market and the process of negotiating subsidy pacts will rely heavily on studies of specific firms, production processes, groups of unemployed workers, and regional disparities. This industrial organization approach will involve elements not central to traditional trade theory – elements that seek, through cost-benefit calculations, to place estimates on the various aspects of the externality-subsidy relationships. Consequently, the analysis and negotiation sector by sector seems most appropriate, together with the recognition that this must be an ongoing process.

NOTES

1 It is not clear whether a government will focus only on externalities as they affect government revenue and expenditures or whether the government will also consider the impact of externalities on other individuals within the political entity. Recently, a substantial literature has developed concerning the ability of individuals to influence a government's decision so as to benefit themselves, see Trebilcock, M.J., D.W. Hartle, J.R.S. Prichard, and D.N. Dewees (1982). The extent to which a government includes externality effects on third parties will depend upon the society's political power structure, see J.R. Melvin 1983. For example, private costs of unemployment caused by a plant closing may or may not be included in a government's calculations. Some economists would argue that at least some private costs should be included, such as loss of income due to job search and retraining, if the political entity's overall welfare is to be maximized. See Ron Saunders, *op. cit.*.

2 It should be noted that, as in other markets, there may be intramarginal purchasers who are able to purchase externalities at a lower price than they would be willing to pay. This may occur because an investment's internal rate of return may vary from one

political entity to another. Investors may choose one particular location in spite of being offered higher subsidies elsewhere.

3 See R.J. Wonnacott in this volume. Although Wonnacott refers to this as a 'modern-day infant protection' argument, it is not the infant industry argument traditionally found in the economics literature nor is it the only argument in favour of subsidies.

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The behaviour of U.S. subsidiaries in Canada: implications for trade and investment

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INTRODUCTION

This paper first presents in summary form details of the primary characteristics of the Canadian subsidiaries of the largest U.S.-based multinational enterprises (MNEs) operating in Canada. Data are reported on the sales, R&D to sales ratio, exports to sales ratio, and performance of each of the 22 largest U.S. subsidiaries. These data are used to interpret some theoretical propositions about why the parent MNE chose to enter the Canadian market by foreign direct investment (FDI) rather than alternative modes of entry. The nature of subsidiary performance is also discussed and related to the behaviour of U.S. parent MNEs and Canadian-based MNEs. Finally I discuss the manner in which recent Canadian policy towards FDI has evolved and drawn reactions from U.S. MNEs as they have adjusted to changes in the environmental parameters imposed by Canadian federal and provincial governments.

The second major theme of the paper is developed in sections which investigate the implications for trade and investments of two critical aspects of the behaviour of U.S. subsidiaries. These are: first, the degree to which R&D can be decentralized by U.S. parents to their Canadian subsidiaries, and second, the contribution made by such subsidiaries to Canadian exports. Other important topics, such as local purchasing requirements and their effect on Canada's imports, cannot be discussed in this short paper. In the latter part of the paper reference will be made to issues of public policy concerning, first, work on Canada's world product mandate policy and its potential effect on parent-subsidiary relationships, and second, evidence of the export performance of subsidiaries and the reasons for their surprisingly good export performance.

IDENTIFICATION AND SIZE OF THE LARGEST U.S. SUBSIDIARIES IN CANADA

The significance of FDI in Canada is well known. Foreign ownership of the Canadian economy is approximately 27 per cent in nonfinancial industries. Certain sectors of the economy have a far greater foreign participation than this, notably fuels at 60 per cent and manufacturing at 43 per cent (see CALURA 1980). The latest *Financial Post* listing of the 500 largest corporations in Canada includes 222 foreign-owned firms, which is 44 per cent of the total. U.S. FDI accounts for the great majority of the FDI in Canada. To keep this study to a manageable size I confine my analysis to the largest 22 of these U.S. subsidiaries in Canada.

The 22 largest U.S.-owned Canadian subsidiaries are identified in Table 1. They are ranked in decreasing order of size, as measured by 1982 Canadian sales. The largest, General Motors of Canada, ranks at number two on the *Financial Post 500* list for 1982. The twenty-second, Westinghouse Canada, ranks at number 104.

One problem with the population of firms in Table 1 is that it is too small to control for industry effects. Given the heavy concentration of foreign ownership in fuels and manufacturing, it is not surprising to find seven and nine firms in these categories respectively. The interpretation of the results in this paper should be qualified by this limitation.

In Canada there is a popular yardstick that everything is 10 per cent of the size of its American counterpart. Thus, it is not unexpected that the mean percentage contribution to parent company sales by Canadian subsidiaries is nearly 10 per cent (shown in the last column of Table 1). Individual subsidiary contributions to parent sales range from 29.5 per cent (Chrysler) to 1.7 per cent (Mobil and Chevron).

EVIDENCE ON THE FINANCIAL PERFORMANCE OF U.S. SUBSIDIARIES IN CANADA

The financial performance of the Canadian subsidiaries and their American parents over the last decade is reported in summary form in Table 2. The conventional measure of performance used is the return

TABLE 1
Size of 22 large Canadian subsidiaries of U.S. multinationals

Subsidiary	Parent	1982 sales (U.S. $000s) Subsidiary	1982 sales (U.S. $000s) Parent	Subsidiary to parent sales(%)
GM	GM	7,752	60,026	12.9
Imperial	Exxon	6,981	97,173	7.2
Ford	Ford	5,942	37,067	16.0
Texaco	Texaco	3,862	46,986	8.2
Gulf	Gulf	3,792	28,427	13.3
Chrysler	Chrysler	2,962	10,045	29.5
Safeway	Safeway	2,673	17,633	15.2
Simpson-Sears	Sears Roebuck	2,541	30,020	8.5
IBM	IBM	1,785	34,364	5.2
Woolworth	Woolworth	1,353	6,590	20.5
CGE	GE	1,324	26,500	5.0
Suncor	Sun	1,250	15,519	8.1
ACT	GTE	1,139	12,066	9.4
Mobil	Mobil	1,005	59,946	1.7
Amoco	Standard (Ind.)	981	28,073	3.5
Dow	Dow	872	10,618	8.2
Du Pont	Du Pont	794	33,331	7.5
K-Mart	K-Mart	765	16,772	4.6
Int'l Harvester	Int'l Harvester	712	4,725	15.1
P and G	P and G	670	11,994	5.6
Chevron	Standard (Ca.)	580	34,362	1.7
Westinghouse	W.E.	573	9,745	5.9
MEAN				9.67

SOURCES: *Financial Post*, 'The Financial Post 500', Annual; *Fortune* 'The Fortune 500 Largest U.S. Industrial Corporations', May issues, 1974-83; *Financial Post Survey of Industrials*; *Canadian Business*, 'The Canadian Business 500', July 1980; corporate annual reports.

on equity (ROE). Return is defined as the net income after taxes while equity is the year-end book value of stockholders' equity. The standard deviation (SD) about the mean of the 10-year ROE is used as a proxy measure for risk. When interpreting these results it is useful to keep in perspective the previous findings in Rugman 1980, 1981, 1982, and by others, that the ROE of MNEs average around 12 to 14 per cent and that there is no significant difference between the reported earnings of MNEs and uninational firms of similar size, or between the reported ROE of parent MNEs and their subsidiaries.

TABLE 2

Performance of 22 large Canadian subsidiaries of U.S. multinationals

	1973-1982			
	ROE-Sub.		ROE-Parent	
Subsidiary	Mean	S.D.	Mean	S.D.
GM	20.1	12.85	12.0	8.11
Imperial	16.1	4.62	16.8	3.28
Ford	8.1	8.74	8.6	7.40
Texaco	17.9	9.25	13.5	4.53
Gulf	15.6	3.38	12.5	2.57
Chrysler	4.6	5.86	3.1	5.29
Safeway	13.8	1.55	13.3	2.47
Simpson-Sears	10.5	3.22	10.7	2.04
IBM	22.7	2.95	19.9	2.06
Woolworth	11.6[a]	2.37	8.8	3.81
CGE	11.2	1.96	17.2	2.51
Suncor	10.7	9.93	14.6	4.09
ACT	5.0[b]	1.65	12.9	1.92
Mobil	24.7	5.06	15.0	4.52
Amoco	18.0	6.70	16.2	2.49
Dow	16.0	9.75	18.5	5.62
Du Pont	9.8	9.80	12.7	3.70
K-Mart	10.2	3.85	14.3	3.75
Int'l Harvester	14.5	9.87	7.4	5.85
P and G	19.0	6.84	17.1	1.06
Chevron	13.2[c]	5.59	15.1	3.63
Westinghouse	14.5	3.47	10.5	4.47
MEAN	14.0	5.88	13.21	3.87

a 1977-82.

b 1974-82.

c 1976-82.

SOURCES: *Financial Post*, 'The Financial Post 500', Annual; *Fortune* 'The Fortune 500 Largest U.S. Industrial Corporations', May issues, 1974-83; *Financial Post Survey of Industrials*; *Canadian Business*, 'The Canadian Business 500', July 1980; corporate annual reports.

In 12 of the 22 cases the subsidiary's ROE exceeds that of the parent although generally at greater total risk. The mean ROE of both subsidiaries (at 14 per cent) and parents (at 13.4 per cent) is not significantly different. But the SD for all 22 subsidiaries is 5.88 per cent compared to that of the parent MNEs at 3.87 per cent. On average, the subsidiaries have similar returns to their parents but the variability of returns, or risk, is substantially higher. Identical results, but for earlier time periods, and especially for MNEs in the petroleum and mineral resource industries were reported in Rugman 1979, 1980. It should be noted from this previous work that the mean return for oil subsidiaries has increased steadily over the last 20 years, while the risk of earnings of mining subsidiaries has decreased.

While the level of profits is the same, why is the mean SD of the subsidiaries more than 50 per cent greater than that of their parents? The answer probably lies in the relatively smaller size of the Canadian economy in which all firms experience more risk than firms operating in the larger and more diversified U.S. economy. Canadian business cycles are typically more pronounced than U.S. ones, reflecting the thin nature of the economy and its dependence on resources. In addition, some of the subsidiaries may be in more specialized activities than their diversified parents; for example, some of the fuels subsidiaries may be engaged in upstream activities. The difference also partly reflects the degree of multinationality of the parent MNEs who are active in more foreign markets than the subsidiaries. The benefits of international diversification for parent MNEs, where offsetting national co-variances tend to stabilize returns were demonstrated for these U.S. MNEs in Rugman 1979.

R&D AND EXPORT PERFORMANCE OF FOREIGN-OWNED SUBSIDIARIES IN CANADA

The 1970s have been characterized by increasing government regulation of the Canadian economy. In the area of FDI much of the nationalistic case for regulation of foreign ownership has been summarized, if not embellished, by the Gray Report (1972). Policy instruments such as the National Energy Program (NEP) and the Foreign Investment Review Agency (FIRA) have sought to increase the Canadian ownership of the economy and to increase the 'net benefits' of FDI, however these are defined. In the context of government support for research and development (R&D) recently a world product mandate (WPM) policy has been advocated by the Science Council of Canada (1980). Under this policy only subsidiaries which have a WPM are to receive R&D grants, whereas present research policy does not discriminate in this manner. With a WPM the subsidiary of an MNE acquires full responsibility for the development, production, and marketing of a single product on a worldwide scale.

The Science Council of Canada views increased R&D as the primary means to increase exports of technologically intensive products. The advanced nations of the world are moving to specialize in more research-intensive goods, leaving the production of standardized product lines to newly industrialized nations such as the four dragons of Southeast Asia. Canada, as a high-income nation, is apparently not making the high-technology transition as rapidly as the others. R&D expenditure in Canada is less than one per cent of GNP, compared to well over two per cent for the United States and most European countries. The Science Council, by recommending policies to encourage WPMs, are assigning part of the blame for the relatively low level of R&D in Canada to foreign subsidiaries.

For Canada to join the high-technology race would imply the creation of a new country-specific advantage (CSA). Canada's current major CSAs are in the exploration, processing, and marketing of raw materials and resources. Only in isolated cases has Canada enjoyed preeminence in a particular technological field. The movement of scarce resources to high-technology industries may be at the expense of Canada's traditional CSAs at a time when considerable improvements in efficiency are required to meet expanding global competition.

The underlying objective of the promotion of WPMs by selective R&D subsidies is to decentralize R&D from parent MNEs to Canadian subsidiaries, but this faces many problems at the MNE level (see Poynter and Rugman 1982 and Rugman and Bennett 1982). These studies applied internalization theory to conclude that parent MNEs would be unwilling to compromise their internal organizational structure by moving towards the decentralization required for WPMs. Thus, the two primary benefits sought by the WPM policy, increased R&D expenditures and more technologically based exports, are both doomed to failure.[2] Furthermore, the WPM policy is not based on a sound assessment of the R&D performance of subsidiaries, which is just as good, if not better, than domestic Canadian firms.

EVIDENCE ON THE EXPORT PERFORMANCE OF SUBSIDIARIES

For the 22 largest U.S. subsidiaries in Canada the evidence on R&D is now examined, as is the export performance of their subsidiaries.

Data on R&D expenditure and export sales are presented in Table 3 for 18 of the 22 subsidiaries. Data for Woolworth, Anglo Canadian Telephone, Simpson-Sears, and K-Mart Canada were not available, so these four U.S.-owned subsidiaries are excluded from further work.

It is to be expected that most U.S. subsidiaries in Canada would be in import-competing sectors, having entered Canada to either avoid the tariff or other barriers to entry. This is difficult to test using these firm level data since Canada is a more open economy than the United States, so its firms should be expected to export more on average. In Table 3 little support is found for the belief that foreign ownership worsens Canada's trade position. It can be observed that exports by six of the subsidiaries exceed those of the six parents at 29.5 per cent and 10.2 per cent respectively.[3] It should also be noted that the largest 22 U.S. subsidiaries are not dominated by resource extraction firms, which might have been expected to export from Canada simply to supply their parents. Instead, most of the 22 subsidiaries use parent firm-specific advantages in technology, knowledge, and other areas to service the Canadian market, so exporting is a bonus.

The export performance of this group of subsidiaries is indeed remarkably similar to that of the nine largest Canadian-owned MNEs listed in Stopford's *Directory*. The mean export-to-sales percentage for these Canadian firms is 28.8, roughly the same as the export performance of the subsidiaries.[4] In addition, Safarian (1979) reports that the export performance of foreign-owned subsidiaries in Canada is similar to that of independent Canadian firms, after adjusting for size and industry effects.

EVIDENCE ON THE R&D PERFORMANCE OF SUBSIDIARIES

Turning from export performance to R&D performance, the mean R&D-to-sales percentages in Table 3 show that ten of these subsidiaries undertake less R&D than their parents at 0.8 and 2.25 per cent respectively. Less R&D in the subsidiaries is to be expected given that the initial reasons for FDI in Canada are either horizontal integration to service the Canadian market from within, thereby avoiding the tariff, or vertical integration to seek resources unobtainable or less attractive in the home country. Compounding these reasons is the need for the MNE to retain property rights over its firm-specific advantage, which requires propriety of R&D knowledge. The parent MNE risks dissipation of its firm-specific advantage in techno-

TABLE 3
Research and export performance of Canadian subsidiaries

Canadian subsidiary (% foreign-owned)	R&D to sales[a] Sub.	 Parent	Exports to sales[b] Sub.	 Parent
General Motors of Canada (100)	0.25	3.47	65.6	25.0[c]
Imperial Oil (74)	0.65	0.53	n/a	74.0[c]
Ford Motor of Canada (92)	n/a	4.30	n/a	49.0[c]
Texaco Canada (90)	0.37	2.33	n/a	0.0
Gulf Canada (75)	1.27	0.55	n/a	38.0[c]
Chrysler Canada (100)	n/a	2.60	n/a	20.0[c]
Canada Safeway (96)	n/a	n/a	4.0[c]	n/a
IBM Canada (100)	1.23	5.73	30.7	6.0
Canadian General Electric (92)	1.53	2.97	n/a	13.0
Suncor (75)	0.45	0.30	19.7	26.0[c]
Mobil Oil Canada (91)	0.35	0.30	n/a	65.0[c]
Amoco (100)	n/a	4.67	n/a	18.0[c]
Dow Chemical Canada (100)	1.00	3.10	20.1	49.0[c]
Du Pont of Canada (75)	0.90	3.20	18.4	12.0
International Harvester Canada (100)	n/a	3.37	43.0[c]	6.0
Proctor and Gamble (100)	n/a	2.17	n/a	32.0[c]
Chevron Canada (100)	n/a	3.33	n/a	53.0[c]
Westinghouse Canada (95)	na	2.30	22.2	14.0
	0.80	2.25[d]	29.5[e]	10.2[e]

a Subsidiary R&D is mean R&D for 1979-82. Parent Company R&D is the mean R&D for 1979-81.

b Figure shown is for the most recent available period: 1980, 81 or 82.

c Foreign Sales to Total Sales, where foreign sales includes both exports of the parent firm plus production by overseas subsidiaries.

d Mean shown is for those ten parent companies for which a comparative subsidiary figure is available. The actual mean for 17 parents is 2.66.

e Mean export sales only, foreign to total sales excluded from computation.

SOURCES: *Financial Post*, 12 March 1983 and 28 November 1981 (R&D). Corporate Annual Reports.

logy when it decentralizes its R&D function. There is a loss of control and a possibility of the subsidiary becoming too autonomous within the organizational structure of the MNE.

Despite these problems, foreign subsidiaries in Canada are observed to at least contribute to the level of R&D performed and their R&D performance is no worse than Canadian-owned firms. Data on R&D at the firm level are limited and few of the comparative studies have been at the firm level. Safarian (1968) did not find any difference in R&D between resident and nonresident firms in his survey. My own research (1981) confirmed this finding and also found that subsidiaries had more R&D than other Canadian firms; the mean R&D-to-sales percentages for groups of the largest 12 parents, subsidiaries, and domestic firms were 3.12, 2.07, and 1.19 respectively.[5]

To extend this work, the R&D-to-sales for 13 Canadian MNEs was calculated for the same time period reported in Table 3. The mean R&D of these Canadian-owned firms is 0.94, which is not significantly different than the mean R&D of the 10 subsidiaries for which data are available.[6] If Northern Telecom, Canada's largest R&D establishment, is omitted the mean falls to 0.44. This similarity in R&D performance (and in export intensity) of U.S.-based subsidiaries and in Canadian MNEs is surprising to many people. They expect the U.S.-based MNEs to be R&D-intensive and Canadian MNEs to be natural-resource-intensive, which implies a far higher R&D-to-sales ratio for U.S. MNEs. Yet this is not observed. Canadian MNEs do as well as subsidiaries of U.S. MNEs in these areas.

The ratio of R&D-expenditures-to-sales for an expanded list of U.S. subsidiaries is given in Table 4. Eleven more subsidiaries (for which data are available) are added to the list of ten in Table 3. All firms are listed in the *Financial Post*'s leading R&D spenders in Canada, so the higher mean R&D-to-sales percentage of 1.73 is to be expected versus 0.80 in Table 3. It is interesting to note that the *Financial Post*'s total sample of leading R&D spenders includes eight government-controlled firms, 22 private Canadian-owned firms, and 21 foreign subsidiaries.

Table 4 also reveals the trends in the ratios of R&D-expenditures-to-sales over recent years. Of the 18 subsidiaries for which data are listed, nine are increasing their R&D-to-sales ratios, six are maintaining their R&D at stable levels, two are fluctuating and only one is in decline. Thus, one-half of the subsidiaries are increasing their R&D-to-sales ratios while another third are maintaining theirs. It is ironic that the WPM initiative is occurring at a time when these subsidiaries are already achieving the Science Council's objective of increased R&D in Canada. Whether new discriminatory subsidies for WPMs will catch this momentum and accelerate it, or stop the trend in its tracks, is a moot question.

With this evidence we can conclude that foreign subsidiaries in Canada do as much R&D as domestically-owned firms.[7] Further, it is

TABLE 4
R&D to sales percentages for selected Canadian subsidiaries of U.S. multinationals

	Parent Co.[a] Mean	Sub. Mean	1982	1981	1980	1979	Trend
General Motors	3.47	0.25	0.3	0.2	n/a	n/a	Stable[b]
Imperial Oil	0.53	0.65	0.6	0.7	0.7	0.6	Stable
Texaco	2.33	0.37	n/a	0.5	0.4	0.2	Rising
Gulf	0.55	1.27	n/a	1.6	1.1	1.1	Rising
IBM	5.73	1.23	1.6	1.2	1.1	1.0	Rising
CGE	2.97	1.53	1.1	1.6	1.9	1.5	Fluctuating
Suncor	0.30	0.45	0.4	0.5	n/a	n/a	NA
Mobil	0.30	0.35	0.2	0.5	n/a	n/a	NA
Dow Chemical	3.10	1.00	1.0	1.0	1.0	1.0	Stable
Du Pont	3.20	0.90	1.2	0.9	0.7	0.8	Rising
Pratt and Whitney[c]	5.93	16.10	21.6	14.6	12.1	15.9	Rising
NCR	n/a	6.78	8.7	7.3	6.0	5.1	Rising
Control Data	n/a	6.08	5.2	5.7	6.3	7.1	Decline
Honeywell	6.17	1.43	2.7	2.0	0.8	0.2	Rising
Xerox	5.57	1.43	1.4	1.3	1.5	1.5	Stable
Litton[c]	1.73	4.10	5.8	2.4	4.1	n/a	Fluctuating
Fiberglas	n/a	1.68	2.0	1.6	1.6	1.5	Rising
General Foods	1.37	1.00	1.0	1.0	1.0	1.0	Stable
Johnson & Johnson	4.87	3.20	3.2	3.2	n/a	n/a	NA
Sheritt Gordon	n/a	1.53	1.8	1.7	1.3	1.3	Rising
Ingersoll Rand	n/a	0.80	1.2	0.4	n/a	n/a	NA
Union Carbide	1.90	0.30	n/a	0.4	0.3	0.2	Stable
MEAN[d]	2.76	1.73					

a 1979-1981.
b Stable is defined as fluctuating by less than 0.2 percentage points.
c Firm has a world product mandate.
d Excludes Pratt and Whitney as unrepresentative of the sample in general.
n/a = not available.
NA = Not applicable, insufficient data available to indicate a trend.
SOURCES: *Financial Post*, 12 March 1983; *Financial Post*, 28 November 1981; Corporate annual reports.

known that the subsidiaries do well in terms of spreading the diffusion of technology to Canada, which is probably just as important as working on new product developments (see the Economic Council of Canada 1983). A policy to encourage R&D in Canada by focusing on any particular so-called deficient group is misdirected. Instead, a nondiscriminatory policy which provides all interested parties with the same incentives for R&D is likely to be beneficial in terms of the number of participants and efficiency of R&D expenditures.

SOME CONCLUSIONS ON CANADIAN POLICY TOWARDS FOREIGN MULTINATIONALS

As discussed at length in Rugman 1980, and confirmed here, the high degree of FDI in Canada has not resulted in an unsatisfactory performance by the subsidiaries themselves. In terms of profitability, R&D capacity and exporting, foreign subsidiaries of U.S. MNEs perform as well as domestic Canadian firms. FDI itself can be largely attributed to two factors: tariffs, and the nature of the Canadian country-specific advantage (CSA).

Since Confederation, Canada, in order to protect manufacturing (and now high-tech industries), has erected tariff (and nontariff) barriers to imports. U.S. MNEs, with close proximity to Canadian markets, have usually regarded Canada as one of the earliest foreign markets to enter, due to the perceived low information costs of exporting to a neighbouring country. As MNEs vied for market shares in import competing sectors in Canada, some found it necessary to keep down their costs by avoiding the Canadian tariff. Thus they switched to Canadian production by FDI. The tariff, while attempting to promote and protect domestically-owned industry, has actually encouraged FDI in Canada by these types of horizontally integrated MNEs.

The second major reason for FDI in Canada is to exploit the country's CSAs in raw materials and resources. Vertical integration has been a factor since resource-based MNEs need to acquire control over raw material inputs in order to reduce interruptions in supply, operate capital-intensive plants at as near-full capacity as possible, and ensure orderly marketing of narrow product lines.

The nature of horizontal and vertical integration by MNEs in Canada has been fostered by inappropriate Canadian policies. Horizontally integrated MNEs can be discouraged by removal of tariffs. Then, many U.S.-based MNEs would export rather than engage in FDI in Canada. Of course, this would now lead to major problems of unemployment and resource reallocation, especially in Southern Ontario. However, one hundred years of inefficiency is no recommendation for another century of myopic Canadian trade policy.

Vertically-integrated MNEs can be discouraged by the development of Canadian-based MNEs. If Canada encourages the development of its own MNEs which build upon its CSAs in resources, energy, and services, then they will act as rivals to U.S.-based MNEs. By building upon Canada's natural CSAs both trade and investment will be encouraged and promoted. R&D can be focused upon Canadian-based MNEs, where this R&D builds upon the natural CSAs of Canada. Novel technologies in the energy, fish, food, and services sectors can be developed by Canadian MNEs, which can gain markets in new global niches.

Such a strategy has been advocated elsewhere (see Rugman 1985). It is a fitting antidote to the current self-inflicted sickness observed in some sectors of the foreign-owned Canadian economy. That the patient has not yet died is a tribute to the efficiency of MNEs, which survive despite the presence of government regulations.

NOTES

1 The author wishes to thank John McIlveen for his excellent research assistance. Helpful comments were also received from Don Lecraw, Bernard Wolf, Danny Shapiro, Harvey Bale, Steven Globerman, Harold Crookell, and Ed Safarian. They may still not agree with all the statements of this short paper.

2 For a more sanguine view of the possibilities of decentralization of R&D through a WPM strategy, see Wolf 1983 and Crookell 1983.

3 Since the sample size is small at six for both subsidiary and parent MNE, caution should be used in interpreting this conclusion, based as it is on inadequate data on exports to total sales. Yet as a mitigating factor consider that both Canadian and American accounting conventions require disclosure of exports when these exceed 10 per cent of sales. Therefore, the large number of firms in both countries not disclosing exports presumably indicates in their cases that the ratio of exports-to-total-sales is less than 10 per cent. Note that most of the U.S. parents do not distinguish between exports from the parent and sales by overseas subsidiaries. If the export-to-total-sales percentages discussed are overstated then this bias should apply to both parents and subsidiaries.

4 These Canadian MNEs are: Northern Telecom, Canada Packers, Noranda, MacMillan Bloedel, Abitibi Price, Molson, Inco, Consolidated Bathurst, and Husky Oil.

5 For R&D findings of a different nature, see Caves, Porter, Spence, and Scott 1980.

6 The 13 Canadian MNEs are: George Weston, Alcan, Northern Telecom, Canada Packers, Noranda, Massey Ferguson, Stelco,

MacMillan Bloedel, John Labatt, Domtar, Abitibi Price, Inco, and Consolidated Bathurst. For details see Rugman 1985.

7 The good performance of the group of U.S. subsidiaries in terms of R&D is all the more remarkable given the recent chastening experience with the compulsory licensing of pharmaceuticals in Canada. Recent government-imposed legislation to substitute the use of generic drugs for the products of drug MNEs after a patent period of only three years has led to the virtual cessation of R&D activity in the subsidiaries of U.S.-based drug MNEs operating in Canada.

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Canadian defence trade with the United States

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The Defence Production Sharing Arrangement (DPSA), which currently implements the principles of economic co-operation in defence between Canada and the United States, was first defined by the Hyde Park Declaration of 1941, and has proven to be of mutual benefit to both the United States and Canada. The program was originally conceived to provide Canadian manufacturers with the opportunity to supply a wide range of defence equipment and services to the United States Department of Defense (DOD), while offering the U.S. DOD a broader industrial base to draw on to meet their defence requirements. The Canada/U.S. DPSA and its companion, the Defence Development Sharing Program (DDSP) which was designed to foster joint research and development, have now been in existence, essentially unchanged, for more than 20 years.

THE MARKET

The DPSA provides U.S. defence-market access for Canadian industry by virtue of the waiver of the 'buy American' act, the removal of customs duties and tariffs, and the free access of U.S. defence products for Canadian defence needs. The arrangement guarantees that Canadian manufacturers are, in essence, domestic sources of supply for both the U.S. military and U.S. prime contractors to the U.S. DOD. However, certain limitations to a North American free-trade zone for defence items do exist. These limitations are significant – for example, the small- and minority-business set-asides which override the DPSA – but these are basically nondiscriminatory and present as much of a problem for larger U.S. corporations as they do for Canadian firms. More important are programs of a highly classified nature which are subject to transfer-of-technology limitations, and those large-dollar-value programs which have high congressional visibility and for which the 'not made here' criteria becomes a significant element to limit the possibilities for Canadian sourcing of these requirements. However, after removing those programs which are restricted or require special consideration, it is estimated that about 60 to 70 per cent of the annual DOD procurement budget should be available for competition by Canadian industry on a regular basis.

CANADIAN DEFENCE EXPORTS TO THE U.S.

The DPSA has served Canadian industry well, with 225 companies obtaining contracts for defence or defence-related items in 1982. Eighty-one of the 225 participating companies had sales of over $1 million, indicating that the bulk of the business is not restricted to a few large corporations. The export sales of all types of defence items to the United States have grown steadily in recent years – $36.7 million in 1979, $481.7 million in 1980, $826.6 million in 1981, $1,027.9 million in 1982 and approximately $714 million for the first six months in 1983. This represents an average annual growth rate of some 42.3 per cent which has more than compensated for inflation (see Table 1).

One of the DPSA objectives is a rough balance of defence trade between the two countries. The cumulative totals from 1959 to date (June, 1983) show Cdn. $7.6 billion in sales from Canada to the United States, while Canadian procurement in the U.S. has amounted to Cdn. $8.73 billion indicating an imbalance over 23 years of Cdn. $970 million in favour of the U.S. The growth in the program in recent years, as indicated by the increase in dollar value of defence exports, the number of companies participating, and the amount of new business being won, indicates that the DPSA remains a sound economic export program which continues to support the growth of high-technology manufacturing in Canada.

Rather than any failure of the DPSA to maintain market access, the present imbalance is due largely to the significantly increased levels of capital purchases from the U.S. in the 1977-1982 time frame, especially of major aerospace-weapon systems such as the CP-140

TABLE 1
Defence trade statistics, 1959 – June, 1983 ($ Canadian millions)

	1959-1980	1981	1982	Jan/June 1983	TOTAL 1959-1983
Procurement in Canada by the United States	5,195.5	826.6	1,027.9	714.0	7,764.0
Canadian procurement in the United States	5,534.9	1,033.8	1,462.4	702.3	8,733.4
U.S. cross-border balance					
In favour of U.S.	339.4	207.2	434.5		969.4
In favour of Canada				11.7	

SOURCE: Unpublished data from Market Research Division, Defense Programs Bureau, External Affairs Canada.

Aurora and CF-18, which have also had major nondefence offsets or industrial-benefits obligations as well.

CANADIAN GOVERNMENT SUPPORT

The present DPSA program is structurally well supported by the Canadian government, and has in place programs in External Affairs such as DDSA, bilateral steering committees, the Department of Regional Economic Expansion, and the Canadian Commercial Corporation. It also benefits from the sourcing activity of the Department of Supply and Services and the defence-sales supports provided by the Department of National Defence. These mechanisms are well defined, and there is good interaction between the Canadian government organizations and their U.S. counterparts. Direct-funding mechanisms available to assist industry are the Program for Export Market Development (PEMD) for market support and the Defence Industry Productivity Program (DIPP) for research, source establishment, and capital assistance, a program which has put over $180 million into Canadian high-tech industry in the past year.

Current bilateral issues which have proven to be impediments to defence-production sharing are technology transfer, the recently solved specialty-metals restriction, and a variety of case-by-case procurement issues. These, however, are being addressed as part of the ongoing process of managing the program by External Affairs and other government departments.

The technology-transfer problem is an ongoing one and could have a long-range influence that could produce vastly different conditions for the Canadian defence industry in the next few years. This might have potential effects on the Canadian high-technology industry, as most of this industry has a commercial-products segment which is dependent on the spin-off from technology related to the defence side.

Although Canadian defence trade with the U.S. currently exceeds by a large margin the trade in this sector with any other country, European and other countries have been successful recently in selling major weapons systems to the U.S. based on indigenous technology.

In conclusion, the defence trade between our two countries is currently healthy, and the growth of major U.S. defence programs should continue this trend in the short term.

In the longer term, protectionism and limitations relating to technology transfer will have to be addressed if the rough balance in Canada/U.S. defence trade is to be maintained.

An Ontario perspective on trade issues between Canada and the United States

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INTRODUCTION

This paper will review the commercial policy dilemmas and options that have faced Ontario as the centre of Canada's manufacturing production over the past century. It will explore how and why there has emerged at times a distinctive Ontario perspective both on U.S. relations in general and on specific trade issues with the U.S. It will also discuss how the province may respond to emerging issues, such as the more vigorous use of U.S. safeguard and fair trade legislation, and to the new trading arrangements with the U.S.

HISTORICAL DILEMMAS

The search for adequate and sure markets has described one of the principal concerns of Ontario's producers from pre-Confederation times to the present. For import-vulnerable producers this has meant a desire to be shielded from foreign competition with tariff barriers and/or quantitative restraints. However, since in many cases the Ontario market alone, has been too small to support efficient scale, another set of Ontario producers have had to seek markets in other parts of Canada or in parts of the world (primarily the U.S.). These factors have raised two sets of dilemmas for Ontario's policymakers. The first has involved the trade-off between its import-vulnerable and export interests. The second has been which of the market access options (Canadian *vs.* export) would yield the most satisfactory economic and political outcome.

Following the repeal of the Corn Laws in the U.K. which removed a tariff preference of value to Ontario's wheat exporters, a conditional arrangement was concluded with the U.S. (the Reciprocity Treaty of 1854) which provided tariff-free entry to imports of a specified list of products. These reflected the Ontario (and Quebec) export interests of that time: grain, flour, animals, meats, seeds, vegetables, poultry, eggs, butter, cheese, tallow, horns, manure, plants, shrubs and trees.

The U.S. moved to terminate the Treaty following Canadian actions which increased tariffs on manufactured products. In turn this led to the introduction of the National Policy of 1879 which put a high protective tariff around Canada's manufacturers and processors; in part to foster manufacturing growth and economic development, and in part to raise revenues to provide the railway infrastructure to knit the country together.

It could be argued that the National Policy was inherently a second-best policy; tariff-free trade with the U.S. would have been a preferred choice although an unrealizable one following the U.S. termination of the 1854 Reciprocity Treaty.

Whether a second best policy or not, there can be little doubt that the National Policy was to suffer from some fundamental contradictions in its principal objectives. The reality of economic development in Canada is that *internal* development was to hinge increasingly on the ability to compete in *external* markets.

That reality has perhaps never been more acutely felt than when the U.S. imposed its extraordinarily high protective tariff rates in 1930 (the Smoot Hawley tariff). The Canadian reaction was first to enact a set of sharp tariff increases and then to create a preferential tariff system within the Empire which would induce Canadian and British firms and subsidiaries of U.S. corporations to produce in Canada for the preferential market.

This policy of Imperial Preferences was quickly found by Canadian producers – not least the manufacturers and processors in Ontario – to offer *no real prospect* for new export markets. Canada's experience with the Smoot-Hawley tariff dramatically illustrates the reality that for a small, export-dependent economy the imposition of a prohibitive import regime by its major market is a destructive act which cannot be offset by any coherent policy.

By 1934 Canada commenced negotiations with the U.S. to achieve mutual tariff reductions. The 1935 Canada/U.S. trade agreement by which Canada lowered duties with the U.S. on a most-favoured-nation

(MFN) basis marks the beginning of modern Canadian tariff policy. A major element in that policy has been to secure reduction *in the U.S. tariff* (on a MFN basis) for particular export products or potential export products. These were negotiated bilaterally in the pre-World War II negotiations and since 1947 have been conducted on a multilateral basis within the framework of the GATT.

The steady reduction in tariffs on manufactured products in most developed countries that has taken place in the postwar period has been accompanied by an explosive growth in world trade in manufactures and by significant restructuring.

For the manufacturing sector in Canada, most of which is still based in Ontario (50 per cent) and Quebec (30 per cent), the result of this restructuring is that less production is destined for the domestic market alone, more for exports. In part this is because Canadian high technology firms are specializing in product niches that are world competitive; in part because lower tariffs are encouraging rationalized production between parents and subsidiaries.

The result is an ever-growing section of the manufacturing sector that is adding its voice to those of the agricultural and resource interests in Canada for better market access, whether through multilateral or bilateral arrangements to reduce foreign market barriers. It is obvious that the U.S., which took almost 90 per cent of Ontario's exports in 1983, will continue to be a market of prime interest and concern.

There is growing recognition, too, that in the post-Tokyo Round environment the problem of market access for Canadian manufacturers will centre around nontariff barriers to trade as well as around the problems of selling to government procurement markets. The U.S. in particular has developed a discretionary, legalistic system that enables it to take flexible action to deal with dumped, subsidized, disruptive or unfair imports. For Ontario producers the question that remains to be answered is whether this new form of protection for U.S. industries will be less trade inhibiting than the high tariffs that it replaces.

Another problem area relates to the very limited agreement under the Tokyo Round to open up the government procurement markets of developed countries. Ontario has seen itself as an efficient producer of urban transit equipment, power generating and transmission equipment, and communications equipment for example. Markets in Europe and Japan still remain almost totally closed to Canadian suppliers; the U.S., too has made access to its market difficult in these sectors.

Ontario's commercial policy interests with respect to the U.S. have therefore reflected the need to balance its changing and growing export interests with its ongoing concern to maintain employment in some of the import-sensitive parts of its economy. This is a fine line to follow in the best of conditions. For Ontario there is the obvious difficulty in reconciling producer and consumer benefits; for the Canadian government the problem is compounded because the balance between export and domestic interests or between producer and consumer interests often splits along regional lines.

In addition, Canadian tariff policy has historically had to contend with the fact that, given the significant amount of economic activity dependent on exporting resources at world prices, or in assembling imported components, Canadian producers need access to low cost machinery, equipment and parts. Therefore, over time, the high protective tariff on manufactured products had been breached in a number of ways:

- First, innumerable end-use items and made/not-made provisions have removed the tariff burden, especially for users of resource and agricultural machinery.

- Second, the introduction, as early as 1904, of an anti-dumping provision made it possible to deal with disruptive low-priced imports from one particular firm without imposing higher defensive tariffs on imports from all sources.

- Third, duty remission measures for imported raw materials, semifinished goods or components encourage lower cost, more rationalized production to take place in Canada.

- Finally, sectoral arrangements with the U.S. in agricultural machinery and automobiles have enabled Canadian producers to realize economies of scale which have meant lower prices and wider choice for farmers and consumers.

Ontario manufacturers have almost invariably found themselves in the middle of this delicate and sometimes creative balance at the federal level between Canadian measures to expand the internationally competitive sectors and those designed to provide protection to home grown industry. The results of these measures has involved positive and negative tradeoffs for Ontario's manufacturing structure thereby continuing to contribute to the ongoing duality of interests in further trade liberalization within the province.

AN EVOLVING ONTARIO ROLE IN TRADE POLICY

The regional nature of the Canadian economy has always been a major defining element in Canada's international trade stance. The past decade however has seen a marked and recognizable evolution in the sensitivity by provincial governments towards international issues and in their desire to participate more actively in its formation. This reflects two factors:

- the growing public and political awareness of the impact of trade developments and foreign competition on provincial jobs and prosperity; and
- the changing nature of trade policy issues which are less concerned now with tariff changes (which are purely a federal responsibility) and more with nontariff issues, such as procurement policies (which could involve entities under either federal or provincial jurisdiction).

The fact that the provinces will in future be more involved in defining and articulating their concerns to the federal government does not automatically imply that Ottawa and any one particular province or region will differ in their definition of issues or on the appropriate policy stance.

This will depend very much on the nature of the consultative arrangements however. In its perspective on Canadian trade policy in the 1980s (see Walker 1982), Ontario stressed that present institutional mechanisms between the federal and provincial governments should be strengthened. In particular

> existing federal-provincial meetings on trade should evolve from information exchange, briefing-debriefing sessions to fora for accommodation, consensus-building and agreement on goals and directions. In some instances, joint policy decision-making should be undertaken. (22)

A recent joint provincial paper on trade policy, 'Views of the Provinces' (1983), stresses the payoff from such a process. It quotes aNewfoundland observation that:

> It is recognized that such a process will undoubtedly lead to more internal debate of trade policy than has previously occurred – the consensus that emerges will be more responsive to the interests and opportunities of the country as a whole. (15)

Nevertheless, consensus will not always be sought, or for that matter, be attainable. The historical and ongoing need for the federal government to balance regional interests always carries with it the risk that no level of government, no region, would be particularly happy with the outcome of a national policy decision, although each may be prepared to live with it.

It has often been implied that in contrast to the majority of smaller provinces, Ontario, because of its economic weight and diversity, finds itself less often in the position of having to accept a federal position in trade policy matters that is at variance with the Province's articulated interests.

In part this attitude reflects the perception that central Canada was the beneficiary of the National Policy at the expense of the rest of the country; in part it reflects the manufacturing benefits to Ontario of major sectoral arrangements with the U.S. in automobiles, defence and agricultural machinery.

The fact is however, that there are numerous examples where the federal government has pursued trade initiatives that not only have had little interest for Ontario but have diverted federal attention and resources away from areas that were seen of greater importance to the province. The Third Option is a case in point. During the period of the 1970s, while this policy held fashion in Ottawa, Ontario's dependence on the U.S. as a market, as a source of investment, and as a supplier of its import needs actually increased.

Another illustration of diverging federal and Ontario attitudes over a major trade policy issue involves developments in the Canada/U.S. auto pact. A budget paper, accompanying the 1976 Ontario Budget, provided a review of the first eleven years under the Pact and identified three fundamental problems that had emerged in the Canadian auto industry, namely: (a) a widening productivity gap, (b) declining Canadian share of auto assembly, and (c) a serious loss in Canadian parts production.

In essence, the Ontario analysis questioned whether Canada was receiving its 'fair' share of investment, production and sourcing under the Pact. While the budget paper indicated that 'the Ontario government does not believe that the Auto Pact necessarily needs to be renegotiated', it did urge federal pressure on the auto manufacturers to ensure, on a long term basis, an appropriate level of production in Canada.

The budget paper was not an isolated expression of Ontario concern on this issue. If anything, it was a very restrained one. The Ontario political rhetoric during the 1970s was much more vehement in hammering home the need for a better deal for Canada under the Pact.

By 1980, Ontario concerns had grown more urgent. In his 1980 budget statement the Treasurer, Frank Miller, made reference to the 'staggering $4 billion in auto parts trade', part of which 'is clearly a chronic deficit reflecting the fact that Canada does not have a fair share of international auto parts production and research and development activities'. The statement made it plain that negotiations were necessary not only with the auto companies, but also with the U.S. government. One key principle in such negotiations would have to be that a 'fair share approach be taken to the allocation of investment and research spending in North America'.

Even today, despite the recent dramatic swing in the auto trade balance in Canada's favour, there are references to Canada's $18 billion cumulative deficit under the Pact and the fair share concept has been widened to include Ontario receiving a fair share of Japan's auto investment in North America. The federal response to Ontario's pressures have been lukewarm. Even the restraints on Japanese automobile imports into Canada only took place to parallel U.S. actions and to prevent massive diversion into Canada given that the European and U.S. markets were restricted to Japanese exporters. It is certainly hard to argue that these measures were taken as a direct result of Ontario pressures.

These examples illustrate that the federal and Ontario perspectives on major trade policy issues have diverged significantly in the past and will undoubtedly diverge in future.

ONTARIO'S STAKE IN THE U.S. RELATIONSHIP

In the specific case of Canada/U.S. relations there are reasons to suspect that the likelihood of significant differences in perspective on a range of issues between the federal and Ontario governments and the potential for divergent policy prescriptions will remain a fact of Confederation.

Canada/U.S. issues are likely to be the particular focus of differences in perspective and emphasis between Ontario and the federal government for the following reasons:

- Ontario has relatively more at stake in the U.S. relationship than the rest of Canada and therefore than Canada as a whole. For example, while almost 90 per cent of Ontario's exports are with the U.S., for the rest of Canada the figure is closer to 60 per cent.
- Over 1,500 subsidiaries are located in Ontario. U.S.-controlled firms account for over half of all manufacturing output in the province.
- Ontario has a disproportionate interest in the continued smooth functioning of certain key Canada/U.S. bilateral arrangements such as the Auto Pact, Defense Production Sharing Agreement and the free trade arrangement in agricultural machinery.

In addition to considerations related to the *intensity* of its economic links with the U.S., Ontario with its major stake in Canada's mineral, forestry and agricultural production, as well as being the country's manufacturing and financial heartland has an obvious stake in a wide *range* of Canada/U.S. developments. By way of example, the following provides an illustrative and by no means exhaustive list of Canada/U.S. issues in 1983 which had important direct economic implications for Ontario:

- Competitive investment incentives employed by U.S. states, such as industrial revenue bonds, which can bias investment decisions to Ontario's detriment.
- Acid rain, which has potentially severe economic implications for Ontario's tourism and forestry sectors, especially in northern Ontario.
- 'Buy America' provisions at both the federal and state level which have had an impact on the U.S. demand for Ontario cement, steel and urban transit equipment.

- U.S. domestic content proposals which would have profound effects on Ontario's auto sector.
- U.S. reciprocity legislation with its potential implications for important Ontario growth sectors such as telecommunications.
- U.S. countervail actions targeted to such products as softwood lumber and potatoes.
- U.S. objection to Ontario's wine-pricing policies and the implications of this for Canadian exports of rye whiskey to the United States.
- Various U.S. contingency protection actions which have harassed or discriminated against Ontario firms. These undermine Ontario as an investment location within the broader North American context.

In most cases Ontario can take a narrower, more parochial and focused view on Canada/U.S. issues and respond to them in terms of their implications for the province's economic development objectives. In contrast, the federal government may have to balance economic considerations with diplomatic or strategic ones. This adds another reason why the Ontario perspective may not necessarily be identical with the Canadian one.

Nevertheless, there is a very real and obvious interest on the part of Ontario in a smoothly functioning and well managed relationship between Canada and the U.S.

Canada and the U.S. are emerging from a period of misunderstanding and tensions. It is the assessment of most observers that relations have improved significantly and that the general perception held by Americans about Canada is positive and likely to remain so. However, a concern exists in Ontario that certain negative perceptions still exist, especially in Washington and that these negative perceptions can and do have an impact on trade and investment flows between the two countries. Some of these U.S. concerns may relate to a perceived interventionist role of government in Canada, or to Canadian policies which are seen as nationalistic, discriminatory, or unfair.

There is a clear and ongoing need to dispel ignorance and significant misperception by Americans about Canada and to reinforce the positive aspects of the relationship. However, given the information overload that characterizes U.S. society, if Canada is to succeed in influencing U.S. decision-makers both the broad Canadian message, and the more focused points that would be brought to bear on specific issues must be put forward in a persistent, coherent and consistent way. If Canadian concerns are to be heeded they must first be heard.

Ontario's recent perspective on Canadian trade policy for the 1980s (Walker 1982) laid major stress on the need to strengthen our image in the U.S. and other markets to improve Canada's relations with the U.S. Among the principal recommendations were:

- the need to stress an image of Canada's technological sophistication in foreign markets, a perception of Canada as an advanced, industrial nation dedicated to innovation, quality and design. To this end the federal government should 'initiate a concerted set of programs, mechanisms and activities to develop a more concrete image of Canada as a valued trading and technological partner' (16).
- the desirability of broadening the cooperative and consultative mechanisms between Canada and the U.S., of improving dialogue at all levels, and of fostering an improved capability to coordinate government policies and business strategies. Consideration should be given to 'establishing Canada-U.S. tripartite committees, committees in a number of key sectors, within the context of a framework agreement, to improve understanding and consultation on economic issues' (17).

There is also an important role for Ontario to play in shaping U.S. attitudes and influencing policymakers, especially on issues of urgent provincial concern.

Over time there have developed an array of agreements and arrangements involving Ontario and Great Lakes States. The Ontario Premier meets regularly with Great Lakes Governors. Other activities involve systematic and widespread visits by the Premier or Ministers to address and discuss important trade issues with the U.S.

Ontario also has had long-established trade-promotion offices in the U.S. The Ontario government has taken steps recently to upgrade its ability to pursue and foster provincial interests in the U.S. The appointment of an Agent General as head of the New York Office reflects the recognition of the need to upgrade Ontario's profile in the U.S. and its ability to influence decision makers. In addition, there is a potential role for the heads of the other Ontario trade offices to be involved in lobbying Congressmen in their home states or districts on the impact on their constituents of negative U.S. actions against key Ontario industries.

Potential areas for expanding Ontario's role involve exposing more senior U.S. public officials, corporate executives and journalists to provincial perspectives on major issues, and workshops between federal and provincial trade officials with their U.S. counterparts.

In sum then, the Ontario perspective on Canada/U.S. developments will at times be quite distinct from the federal perspective or even that of other provinces. This reflects Ontario's relative emphasis on the importance of economic issues over diplomatic or strategic ones; the desire to see that the broad relationship is kept on a harmonious course given the enormous and disproportionate stake Ontario has in two-way economic flows: the need to ensure a positive Canadian profile in the U.S. so as to foster future growth opportunities; and (within its constitutional parameters) an emerging conviction that the Province needs to intervene, lobby, or inform in order to resolve the provincially-sensitive sectoral or industry specific problems that arise out of the U.S. legislative process.

FUTURE DEVELOPMENTS

The present framework of commercial relations between Canada and the U.S. is the result of a long series of deliberate policy decisions some of which were negotiated bilaterally, others in a multilateral context. One of Canada's prime objectives throughout this process was to negotiate predictable access to a market large enough to foster specialization and competitive levels of productivity in export sectors.

Despite the progress that has been made in terms of improved market access to the U.S. in recent decades both through the multilateral framework of the GATT (the Kennedy and Tokyo Round negotiations) and bilaterally (the auto pact), Canadian industrial productivity continues to lag behind that of the U.S. In part, this continues to reflect the relatively small size of plants in Canada, which makes it difficult for Canadian industries that are not heavily export-oriented to achieve optimal scale economies or economies of specialization to minimize their production costs.

In a recent discussion paper for the Economic Council of Canada, Baldwin and Gorecki demonstrate that increases in market access that followed the Kennedy Round are correlated with increases in average plant size in Canadian industry (from 61 per cent of U.S.

average in 1970 to 64 per cent in 1979). However, plant size falls significantly short of U.S. norms in most industries other than the export-oriented ones. This is demonstrated in Table 1.

The paper suggests that there may be substantial productivity and efficiency gains from continued Canadian initiatives to improve market access in the U.S. Despite these observations, however, there are reasons to question whether this would indeed be the optimum strategy for Canada to pursue in the future.

The uncertainty derives from a number of factors; namely, those resulting from changes in manufacturing technology, and those that relate to the international trade policy environment.

In terms of manufacturing processes, the following questions will need to be addressed:

- will flexible manufacturing systems make production economies available for batch production that in the past were available only to massive scale operations?

- will the learning curve for most production processes become eliminated or redundant with such flexible manufacturing systems, again enabling small scale producers to compete on an even footing with large scale producers?

- will the use of CAD/CAM neutralize any of the learning curve advantages in product design or system design that larger scale producers might possess?

In terms of trade policy considerations the following issues will have to be debated:

- as considerations of market access shift from tariff reductions to reductions in nontariff barriers (even to the extent of encompassing investment policies) will it be possible to establish a consensus in Canada that will accept the desirability of trading off 'sovereignty' for efficiency, especially given that significant nontariff issues are under provincial jurisdiction?

- will it be possible in either a multilateral or a bilateral context to come to grips with issues of managed trade, i.e., the growing significance of countertrade, production sharing, and intra-firm transfers within multinational corporations.

TABLE 1
Relative plant scale of Canadian manufacturing industries compared with U.S. averages

	Size of large Cdn. plants as % of large U.S. plants	
	1970	1979
Export oriented industries		
Paper & allied industries	103	105
Wood industries	99	100
Primary metal	92	86
Metal fabricating	117	97
Nonmetallic minerals	96	132
Rationalized (two-way trade flows)		
Transportation equipment	55	77
Electrical products	59	41
Machinery	125	47
Petroleum & chemical products	138	97
Chemicals or chemical products	57	76
Low trade industries		
Food & beverages	52	57
Tobacco products	27	100
Publication & printing	56	55
Miscellaneous manufacturing	36	44
Import competing industries		
Leather	75	85
Textiles	58	58
Knitting mills	41	31
Clothing	55	80
Furniture and fixtures	29	19

SOURCE: Adapted from results in Baldwin and Gorecki (1983).

An unpublished background paper prepared for Ontario's submission to the MacDonald Commission (Ministry of Industry and Trade 1983) points out that the relevance of the GATT as a framework of mutually agreed rules is undermined by the growth in managed trade and manipulated competitiveness. The paper indicates that 'marketing arrangements' such as those affecting trade in autos, steel, agriculture, textiles and clothing and footwear have been estimated in affect up to 30 per cent of world trade. In addition, countertrade now accounts for at least 10 per cent of world trade and intra-corporate trade within multinational corporations another 10-15 per cent. Another factor of concern is that global trade in services – one of the potential growth areas in the world economy – is not covered by any framework of agreed international rules. The GATT will find it very difficult and very slow going in coming to grips with these 'new' elements and whereas it might be possible to make greater headway with the U.S. alone on some issues (perhaps on services and intra-corporate trade) the question again must be raised as to whether U.S. demands would be worth paying for.

Coinciding with this growing set of concerns about the relevance of the GATT are questions about the desirability, indeed the necessity to continue to emphasize export-led growth. In the past, a significant part of the rationale for the export thrusts of both federal and provincial governments in Canada has been the need to offset imports: imports that have provided consumers with diversity and low cost options; imports of capital goods, parts and imported services that have provided other producers with efficient inputs to maintain their competitiveness.

Will it be possible in future to balance, in part, this export imperative by pursuing domestic measures that encourage *competitive* import substitutes if, for example, these can be attained through flexible manufacturing systems?

It is against the backdrop of these questions that the discussion about new trade ventures vis-à-vis the U.S. (whether on a bilateral basis or a multilateral one) should be addressed. It will be very surprising if on the specific issue of free trade with the U.S. the Ontario approach is anything but practical, pragmatic, and piecemeal. Certainly the U.S. is seen as a major area of export growth for Ontario over the coming decade, and the U.S. market access will be essential to the attainment of Ontario's export targets However, Ontario will approach any new Canadian initiatives with caution.

One of the clearest statements of Ontario's perspective on any future alterations in the Canada/U.S. economic framework was made in 1981 by former Minister of Industry and Tourism, Larry Grossman. In a presentation to the Van Roggen Committee he stated:

> I think those that really dream of pure free trade with the United States must understand that they are really advocating the giving up of our sovereignty in so many areas that we will ultimately end up being part of the United States.

> There may be a middle ground for a couple of years, but when you look at all the different labour, environment and social ground rules that would need to be brought into a state complementarity we wouldn't just stay there. What we are really saying is that in certain sectors where it would benefit our economy, structured, carefully negotiated bilateral freer access to the American market is what is required. (Grossman 1981, 26)

This theme was echoed on Ontario's perspective on Canadian trade policy for the 1980s:

> For a variety of reasons, Ontario believes that relations between the two countries are unlikely to evolve in the direction of a free trade agreement in the foreseeable future. From a Canadian perspective, many unanswered questions remain and the ramifications of free trade for our economic and political sovereignty are not fully understood. In short, total free trade appears to be an unrealizable and quite likely undesirable option.
>
> However, other avenues exist for securing improved access for Canadian firms to the U.S. market. It is recommended that these be the subject of further study. Canada and the United States should explore the possibility for arrangements to promote an expanded level of bilateral trade in specific industrial sectors. (Walker 1983, 17)

Both Premier Davis and the Minister of Industry and Trade, Frank Miller, are on record as supporting the Canadian governments initiative to *explore* the potential for sectoral free trade with the U.S. However, this has never implied any commitment to support any specific new arrangements irrespective of their parameters or their outcome.

Ontario's evaluation of any future deals will undoubtedly reflect its experience under existing sectoral arrangements such as the auto pact. As such any final Ontario evaluation will give significant consideration not only to the economic dimensions, but also the way in which potential arrangements are structured to reflect political and social differences and sensibilities. In this respect then (over and above consideration of a reciprocal balance of benefits), the following factors will loom large in the evaluation criteria that Ontario would bring to bear in weighing future deals:

1 Can any new sectoral arrangements be constructed so as to be adaptable to changing external conditions?
2 Can they deal effectively with nontariff as well as tariff barriers?
3 Can exceptions from the reach of certain types of domestic legislation be built into such arrangements?
4 Should the objectives and expectations of any given sectoral arrangement be set out clearly and in a mutually agreed fashion as part of the arrangement?
5 Can effective mechanisms to monitor, police and enforce the provisions of these arrangements be agreed and established?
6 Can mechanisms be built into any arrangements to insulate them from downstream potential pressures?
7 Can transitional arrangements acceptable to both sides be formulated?
8 Can compensation clauses be agreed to in advance that address significant departures from any agreement?
9 Will the price for preferential arrangements with the U.S. be worth paying; will the outcome of nonpreferential deals which would be open to Japanese, European and Third World competitors, provide the benefits desired?

CONCLUSIONS

The U.S. will continue to be a market of paramount importance to Ontario and, as such, the province will continue to try to shape Canadian policy towards the U.S., and whenever possible to shape events or policies that affect its interest within the U.S.

There is a very high degree of uncertainty as to how strongly Ontario will push for or support Canadian initiatives to enter into new trade pacts with the U.S. In part, this reflects fundamental questions about whether such arrangements can structured to respond both to Ontario's economic and political concerns.

In part, it reflects unresolved issues as to whether recent changes in production technology will make it possible to provide consumers and other producers with products or inputs at competitive prices despite producing from a small production base.

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Postscript

The conference at which the papers and discussants' remarks contained in this volume were presented was planned at a time when the atmosphere for trade policy on both sides of the Canada/U.S. border was very different from now. American concerns over the National Energy Program in Canada and the Foreign Investment Review Agency were pronounced and vocally expressed. Hence, the use of the word 'conflicts' in our title.

Since the conference was held in 1983, a number of developments have served not only to reduce the level of conflict but, at least in Canada, to elevate sharply the discussion of a possible Canada/U.S. free trade arrangement. The Review of Canadian Trade Policy published by the Department of External Affairs in 1983 discussed the possibility of limited sectoral free trade arrangements with the U.S., and was quickly welcomed by the U.S. administration as a positive sign. Subsequently, there has been the election of a new government in Canada, a further Canadian government discussion paper on trade policy, movement on the multilateral front at the Bonn Summit, and actions in the U.S. on steel (with VERs introduced) and autos (with VERs removed).

Currently, Canada/U.S. trade arrangements seem to be at a critical juncture. The level of support in Canada for a free-trade initiative towards the U.S., while far from unanimous, seems stronger than for many a year. On the other hand, Canada has endured threats of restricted market access to the U.S. for steel and copper over the last 18 months, and now faces renewed countervail problems with lumber, pork, and other items. On the U.S. side, a bilateral initiative with

Canada has always seemed a useful device for putting added pressure on the EEC and Japan to come to the multilateral negotiating table; but once this has been achieved the momentum for any bilateral trade policy accommodation with Canada seems likely too slow. Also the pressures for U.S. protection from a strong dollar and sense of grievance towards Japan are clearly present.

How Canada/U.S. trade arrangements will evolve in the future remains to be determined. However, even though commissioned at a time when debate on Canada/U.S. trade issues took place on a different plane than much of the subsequent discussion, we still feel that many of the pieces in this volume will stand the test of time and contribute to policymaking in the two countries in the years ahead.

The Editors

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